CHRISTOPHER S. BOND, MISSOURI, CHAIRMAN
CONRAD R. BURNS, MONTANA
PAUL COVERDELL, GEORGIA
ROBERT F. BENNETT, UTAH
OLYMPIA J. SNOWE, MAINE
MICHAEL ENZI, WYOMING
PETER G. FITZGERALD, ILLINOIS
MIKE CRAPO, IDAHO
GEORGE V. VOINOVICH, OHIO
SPENCER ABRAHAM, MICHIGAN

JOHN F. KERRY, MASSACHUSETTS
CARL LEVIN, MICHIGAN
TOM HARKIN, IOWA
JOSEPH I. LIEBERMAN, CONNECTICUT
PAUL D. WELLSTONE, MINNESOTA
MAX CLELAND, GEORGIA
MARY LANDRIEU, LOUISIANA
JOHN EDWARDS, NORTH CAROLINA

EMILIA DISANTO, STAFF DIRECTOR
PATRICIA R. FORBES, DEMOCRATIC STAFF DIRECTOR

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, DC 20510–6350

December 12, 2000

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:

It has come to my attention that the Treasury Inspector General for Tax Administration (TIGTA) recently completed a review of the Internal Revenue Service' (IRS) processing of corporate tax returns. In part, TIGTA's Letter Report, entitled "More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provisions" (Reference Number: 2000-30-019), found that more than 2,000 small corporations may have overpaid their taxes due to an unawareness or misunderstanding of the small-corporation exemption from the alternative minimum tax (AMT) under section 55(e) of the Internal Revenue Code of 1986, as amended. Of the small corporations sampled by TIGTA, 93% qualified for the small-corporation exemption and erroneously paid an average of $11,638 in AMT. As a result, in tax year 1998 these small-corporate taxpayers appear to have overpaid the Federal government by more than $25 million.

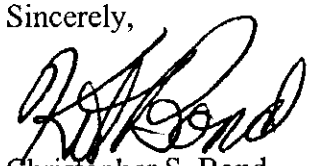
TIGTA's findings are especially troubling because there is no automatic system under which these taxpayers will receive a refund of their overpaid taxes or even be made aware of their error. Had the error resulted in an underpayment, the IRS would rightly send a notice and demand for payment. In this case, however, the small-corporate taxpayers will only receive a refund if *they* realize *their own* mistake and file an amended tax return. In an area of tax law as complex as the AMT, that is a lot to expect from small businesses struggling to comply with the overly complicated tax law while running a successful enterprise. In fact, it is highly likely that these small-corporate taxpayers will repeat the same mistake in the future if it is not brought to their attention.

In keeping with the IRS' mission of providing top quality service by helping taxpayers understand and meet their tax responsibilities, I request that you give prompt attention to steps that can be taken to assist small corporations that have overpaid their taxes and to help all small-corporate taxpayers avoid such overpayment as a result of the AMT in the future. I understand that TIGTA's report includes detailed recommendations for addressing this matter and that the IRS did not submit comments concerning those recommendations. Accordingly, I would appreciate your providing me with the agency's views on each recommendation, including the actions that you are taking to implement them.

The AMT is clearly an area of the tax law in dire need of attention. As the Chairman of the Senate Committee on Small Business, I will continue my efforts to enact a simpler, fairer, and flatter tax code. Toward that end, I would welcome your thoughts on the steps that need to be taken so that taxpayers who make errors in their favor, such as the AMT overpayment highlighted by TIGTA, will automatically receive a refund once the IRS identifies the mistake. Such a system, which I understand exists in some states, would dramatically reduce the tax burdens on America's taxpayers.

Thank you for looking into the matter and taking appropriate action to ensure that small-corporate taxpayers are not overpaying their taxes. With the statute of limitations continuing to run on refunds in these cases, I would appreciate receiving your reply to the issues raised above by January 5, 2001. 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, the Committee's Tax Counsel, at (202) 224-5175.

Sincerely,



Christopher S. Bond
Chairman

Letter Report: More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision

November 2000

Reference Number: 2000-30-019

This report remains the property of the Treasury Inspector General for Tax Administration (TIGTA) and may not be disseminated beyond the Internal Revenue Service without the permission of TIGTA.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

November 24, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report – More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision

This report presents the results of our review of the Internal Revenue Service's (IRS) processing of corporate tax returns affected by several recent legislative provisions; and taxpayers' ability to comply with these provisions.

In summary, some taxpayers who appeared to be exempt from paying the corporate alternative minimum tax may have mistakenly paid this tax. We recommended that the IRS enhance its efforts to inform taxpayers and tax professionals of the exemption from the alternative minimum tax for small corporations. Our recommendations could provide additional taxpayer entitlements for over 2,000 small business corporate taxpayers who may have paid $25 million in alternative minimum tax for which they were not liable. Appendix III of this report provides a detailed description of these benefits, which will be included in our Semiannual Report to the Congress.

In discussing our draft report with IRS officials, they expressed concern that it did not acknowledge that there may have been factors not indicated on tax returns that caused some of the corporations not to qualify for the exemption from the alternative minimum tax. As a result, we added such language to our final report. In addition, we contacted a small sample of taxpayers to determine if the factors referred to above were applicable in their cases, or if they had paid the alternative minimum tax in error. All of the taxpayers responding to our inquiry (or their representatives) stated that there were no factors or circumstances that precluded them from taking advantage of the exemption from the alternative minimum tax, and they had, in fact, paid the alternative minimum tax in error.

Management's written response to our draft report was due on October 2, 2000. As of November 20, 2000 management had not responded to the draft report.

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 your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

Objectives and Scope

The objectives of this audit were to determine if the Internal Revenue Service (IRS) correctly processed corporate tax returns affected by several recent legislative provisions and to evaluate the taxpayers' ability to comply with these provisions.

We identified four provisions from new tax legislation and reviewed corporate returns relating to these provisions.

To accomplish our objectives, we analyzed tax legislation to identify provisions affecting the IRS' processing of corporate returns. We identified the following four provisions which we considered to be significant based on the number of taxpayers affected, anticipated revenue impact, sensitivity of the issue, and complexity of the issue:

- Research Tax Credit.
- Work Opportunity Credit.
- Welfare-to-Work Credit.
- Alternative Minimum Tax Exemption for Small Corporations.

Appendix IV contains a brief explanation of these four legislative provisions.

We then identified Tax Year 1998 corporate income tax returns affected by these provisions and conducted computer analyses of data on the returns. We sampled and reviewed these tax returns to determine whether:

- The taxpayers filed the returns correctly.
- The IRS processed the returns correctly.

We conducted this audit from October 1999 to June 2000.[1] Audit work was conducted in the Ogden IRS Center in accordance with *Government Auditing Standards*.

---

[1] In response to concerns raised by IRS officials, we contacted a small sample of taxpayers after the draft of this report was issued. We received the last taxpayer's response on November 20, 2000.

Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List.

Background

From 1996 through 1998, the Congress enacted legislation that was considered the most extensive and complicated the IRS faced since 1986.[2] The Taxpayer Relief Act of 1997 alone contained over 800 amendments and nearly 300 new provisions. Several of these provisions affected the processing of many of the over 5 million corporate income tax returns that the IRS receives each year.

The mission of the IRS is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. To help accomplish this mission and to lessen the burden on taxpayers, the IRS has committed to work with taxpayers earlier in the tax return filing process to promote taxpayer compliance. This includes improving returns processing, identifying issues early and adjusting refunds, telling taxpayers about recurring problems, and improving forms and publications.

---

[2] This legislation included the following Acts:

- Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.
- Taxpayer Relief Act of 1997, 26 U.S.C. § 1 et seq. (1999).
- IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.
- Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681-886.

Results

The IRS properly processed most corporate tax returns affected by three of the four recent legislative provisions that we reviewed. Generally, taxpayers properly applied the laws to their particular tax situations for these provisions.

Some taxpayers may have experienced problems with the alternative minimum tax exemption for small corporations.

However, some taxpayers may have experienced problems with preparing tax returns that qualified for the small corporation exemption from the alternative minimum tax. This report outlines steps the IRS should take to help prevent these problems in the future. Recommendations in this report could provide additional taxpayer entitlements to over 2,000 small business corporate taxpayers who may not be aware of the exemption from alternative minimum tax.

Small Corporations Appearing to Qualify for an Exemption from the Alternative Minimum Tax May Have Paid the Tax in Error

Small corporations appeared to have erroneously filed and paid over $25 million in alternative minimum tax.

Over 2,000 businesses that appeared to qualify as small corporations may have erroneously filed and paid over $25 million in alternative minimum tax. Based on the information available from these businesses' corporate tax returns, they appeared to have been exempted from this tax by recent legislative changes.[3]

[3] There are factors not indicated on the tax returns that may have caused some of these corporations not to qualify for the exemption from the alternative minimum tax. Specifically, a corporation can lose its status as a small corporation because it is aggregated with one or more corporations under Internal Revenue Code (IRC) §448(c)(2) or treated as having a predecessor corporation under IRC §448(c)(3)(D). However, we contacted a sample of nine taxpayers to determine if these factors applied to their businesses. All of the taxpayers responding to our inquiry (or their representatives) stated that there were no factors existing that precluded them from taking advantage of the exemption from the alternative minimum tax, and they had, in fact, paid the alternative minimum tax in error.

Many taxpayers and their tax professionals may have overlooked their qualification for the small corporation exemption from the alternative minimum tax. Without significant manual effort, the IRS could not identify these errors. As a result, these taxpayers were not informed of their errors and, accordingly, are likely to repeat them.

The Taxpayer Relief Act of 1997 provided an exemption from the alternative minimum tax for qualified small business corporations for tax years beginning after December 31, 1997. A corporation qualifies as a small corporation if it meets the gross receipts tests of Internal Revenue Code § 448(c).[4] Once a corporation qualifies as a small corporation, it will not be liable for the alternative minimum tax so long as it remains a small corporation.

We identified 2,343 Calendar Year 1998 returns that had paid the alternative minimum tax and appeared to meet the gross receipts criteria to qualify as small corporations. In a statistical sample of 150 of these returns, 139 (93 percent) qualified for the exemption but had self-assessed an average of $11,638 in alternative minimum tax. Based on this sample, we estimate that 93 percent (2,178) of the 2,343 corporations in our population paid over $25 million in alternative minimum tax that recent legislation specifically exempted.[5] It is reasonable to assume that corporations that filed fiscal year returns

---

[4] Internal Revenue Code, 26 U.S.C. §448(c).

[5] Our test included calendar year taxpayers whose tax year ended December 31, 1998, because this was the first full tax year to which the new exemption applied. Many more taxpayers have tax years that end in a month other than December. These are referred to as fiscal year taxpayers. We identified an additional 7,394 fiscal year taxpayers who paid alternative minimum tax on tax returns filed during 1998 and who appeared to qualify as small corporations. Although the alternative minimum tax exemption for small corporations did not apply to these fiscal year taxpayers until their subsequent year's tax return, it is reasonable to assume that some of these taxpayers would overlook the exemption as did the calendar year taxpayers.

subsequent to our sample selection and which were not included in our population would have also made the same errors.

The Taxpayer Relief Act of 1997 contained over 800 Internal Revenue Code amendments and nearly 300 new provisions, approximately half of which were effective for Tax Year 1998. Tax professionals had to understand these many changes over a short time and may have overlooked the qualification for the small corporation exemption from the alternative minimum tax.

Recommendations

The National Director, Education, Walk-In, and Correspondence Improvement,[6] should:

1. Issue a public announcement to taxpayers to emphasize the alternative minimum tax exemption for qualifying small corporations.
2. Enhance taxpayer education materials (including those on the internet) to emphasize the alternative minimum tax exemption for qualifying small corporations.

Management's Response to the Draft Report: Management's response was due on October 2, 2000. As of November 20, 2000, management had not responded to the draft report.

Conclusion

Taxpayers properly prepared, and the IRS properly processed, most corporate income tax returns affected by three of the four recent legislative provisions that we

[6] Effective October 1, 2000, responsibility for this action would belong to the Small Business/Self-Employed Director, Taxpayer Education and Communication.

reviewed. However, over 2,000 small corporation taxpayers appeared to have overpaid alternative minimum tax of $25 million from which they were specifically exempted. The IRS should enhance educational materials and issue a public announcement to emphasize the alternative minimum tax exemption.

Appendix I

Major Contributors to This Report

Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs)
Richard J. Dagliolo, Director
Kyle R. Andersen, Audit Manager
Kyle D. Bambrough, Senior Auditor
Greg A. Schmidt, Senior Auditor
Roy E. Thompson, Senior Auditor
W. George Burleigh, Auditor

Appendix II

Report Distribution List

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

Appendix III

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 the Congress.

Finding and recommendation:
Over 2,000 businesses that appeared to qualify as small corporations may have erroneously filed and paid over $25 million in alternative minimum tax.

The National Director, Education, Walk-In, and Correspondence Improvement,[1] at the Internal Revenue Service (IRS) should issue a public announcement to taxpayers to emphasize the alternative minimum tax exemption for qualifying small corporations and should enhance taxpayer education materials to emphasize the alternative minimum tax exemption for qualifying small corporations.

Type of Outcome Measure:
Taxpayer Entitlements - Potential

Value of the Benefit:
Based on information available from tax returns, we estimate that 2,178 taxpayers (93 percent of our population of 2,343) may have computed and overpaid $25 million in alternative minimum tax for which they were not liable. These figures would be significantly higher if applied to all returns (including fiscal year ending) filed during the full tax year after which this provision became effective. Our review included returns ending December 31, 1998. It did not include subsequent fiscal year returns.

Methodology Used to Measure the Reported Benefit:
We computer identified 4,020 corporate returns with tax years ending December 31, 1998, that had claimed alternative minimum tax and had gross receipts that qualified for treatment as small corporations. We then eliminated taxpayers who had filed consolidated returns, or for whom the IRS had identified math errors or misplaced entries that resulted in zero alternative minimum tax actually assessed. We reviewed a

[1] Effective October 1, 2000, responsibility for this action would belong to the Small Business/Self-Employed Director, Taxpayer Education and Communication.

statistically valid sample of 150 of the remaining 2,343 returns (95 percent confidence level +/- 5 percent).

Appendix IV

Key Legislative Provisions Affecting Corporate Returns Processing Included in This Review

Legislative Provision	Brief Overview
Research Tax Credit	The research credit is a tax credit based upon qualified research and experimental expenses incurred by a trade or business. The credit generally equals 20 percent of the amount by which research expenditures exceed a base amount. Taxpayers are required to reduce their research expense deductions by the amount of the credit. Taxpayers may elect an irrevocable alternative incremental research credit for any tax year beginning after June 30, 1996. The research credit was originally enacted in 1981 and has been modified and extended repeatedly. The research tax credit expired and did not apply to amounts paid or incurred after June 30, 1995. The Small Business Job Protection Act of 1996[1] extended the research tax credit for the period July 1, 1996, through May 31, 1997. The Taxpayer Relief Act of 1997[2] extended the credit for 13 months, from the period June 1, 1997, through June 30, 1998. The Tax and Trade Relief Extension Act of 1998[3] extended the credit through June 30, 1999.

[1] Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.
[2] Taxpayer Relief Act of 1997, 26 U.S.C. § 1 et seq. (1999).
[3] Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681-886.

Work Opportunity Credit

The Work Opportunity Credit is a tax credit to employers who hire individuals belonging to one of eight targeted groups. The credit generally equals 40 percent of qualified first-year wages up to $6,000 for certified workers who work at least 400 hours in the first year (maximum credit of $2,400 per certified worker). The credit percentage is reduced to 25 percent of qualified first-year wages for certified workers who work at least 120 hours but less than 400 hours. Taxpayers must reduce their wage expense deductions by the amount of the work opportunity tax credit.

The Small Business Job Protection Act of 1996 redesignated the Targeted Jobs Credit as the Work Opportunity Credit. This provision is effective for wages paid or incurred to a qualified individual who begins work after September 30, 1996, and before October 1, 1997. (The targeted jobs tax credit previously expired and did not apply to wages paid to individuals who began work after December 31, 1994.) The provision also changed the credit percentage from 40 percent to 35 percent and changed the targeted groups from 9 to 7.

The Taxpayer Relief Act of 1997 extended the effective date for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1997, and before July 1, 1998. The 1997 Act also increased the number of targeted groups from 7 to 8 and changed the credit percentage from 35 percent to 40 percent. Also, if an individual performs at least 120 hours but less than 400 hours, the credit percentage is reduced to 25 percent.

The Tax and Trade Relief Extension Act of 1998 extended the credit and made the provision effective for wages paid or incurred to a qualified individual who begins work for an employer after June 30, 1998, and before July 1, 1999.

Welfare-to-Work Credit

The Welfare-to-Work Credit is a new credit established by the Taxpayer Relief Act of 1997 and is available to employers for wages paid to long-term family assistance recipients during the first 2 years of employment. The amount of the credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 ($3,500 first year and $5,000 second year) per qualified employee. Taxpayers must reduce their wage expense deductions by the amount of the welfare-to-work tax credit.

The Taxpayer Relief Act of 1997 made this provision effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before May 1, 1999. The Tax and Trade Relief Extension Act of 1998 extended the credit and made the provision effective for wages paid through June 30, 1999.

Alternative Minimum Tax Exemption for Small Corporations

The Taxpayer Relief Act of 1997 repealed the corporate alternative minimum tax for small corporations meeting certain gross receipts tests. The corporation will not be liable for alternative minimum tax so long as it remains a small corporation.

A corporation initially qualifies as a small corporation if it had average gross receipts of $5,000,000 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 (IRC) section 448(c)(2) or treated as having a predecessor corporation under IRC section 448(c)(3)(D).

Once a corporation is recognized as a small corporation, it will continue to be exempt from the

alternative minimum tax for so long as its average gross receipts for the prior 3-year period do not exceed $7,500,000.