

**Opportunities Exist to More Effectively
Process Personal Service Corporation Income
Tax Returns**

September 2001

Reference Number: 2001-30-165

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 27, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Opportunities Exist to More Effectively
Process Personal Service Corporation Income Tax Returns

The report presents the results of our review of the Internal Revenue Service's (IRS) processing of Personal Service Corporation Income Tax Returns. The objectives of this review were to:

- Evaluate the IRS' efforts to help taxpayers comply with filing requirements for personal service corporation income tax returns.
- Determine if the IRS correctly processed personal service corporation income tax returns.
- Evaluate taxpayers' abilities to comply with the tax laws related to personal service corporations.

In summary, we found that the IRS does not have a process to identify those taxpayers that do not file correctly. In Tax Year (TY) 1999, over 10,400 personal service corporations with taxable income may have underpaid their taxes by over \$15 million.

Management's response was due on September 24, 2001. As of September 25, 2001, 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 Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**Opportunities Exist to More Effectively Process
Personal Service Corporation Income Tax Returns**

Table of Contents

Background	Page 1
Personal Service Corporations that Are Not Complying With the Flat Tax Rate Should be Identified.....	Page 2
<u>Recommendations 1 and 2:</u>	Page 3
The Internal Revenue Service Needs to Ensure Accurate Personal Service Data Is Entered on Tax Returns and Input to Its Computers.....	Page 3
<u>Recommendation 3:</u>	Page 5
<u>Recommendation 4:</u>	Page 6
Manual Procedures Could be Replaced With More Reliable Automated Processes.	Page 6
<u>Recommendation 5:</u>	Page 7
Appendix I – Detailed Objectives, Scope, and Methodology	Page 8
Appendix II – Major Contributors to This Report.....	Page 12
Appendix III – Report Distribution List.....	Page 13
Appendix IV – Outcome Measures.....	Page 14

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

Background

A corporation is classified as a personal service corporation if substantially all the corporation's activities involve the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. This definition also requires substantially all the corporation's stock to be owned directly or indirectly by employees. Employees may include individuals, retired employees, or the estate or heirs of an employee. Personal service corporations are eligible for relief from the provision requiring corporations to use the accrual method of accounting; however, they are subjected to a flat 35 percent tax rate as opposed to the lower graduated tax rates, which begin at 15 percent, that are normally applicable to corporations.

A personal service corporation can limit the impact of higher tax rates by paying out reasonable wages to the employees. The corporation's taxable income will be reduced and the income will be shifted to personal returns subjected to the individual graduated tax rate.

In 1997, the Internal Revenue Service (IRS) issued an announcement to alert taxpayers and practitioners that many personal service corporations had filed using the graduated corporate tax rate, which understated their tax liability. At that time, practitioners attributed the problem to difficulties with using certain computer tax software programs, while others acknowledged the mistakes as unintentional oversights.

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. In an effort to lessen burden on taxpayers, the IRS has committed to take actions sooner to promote taxpayer compliance. This includes improving returns processing, identifying issues early, telling taxpayers about recurring problems, and improving forms and publications.

We conducted our audit of the IRS' processing of personal service corporation returns from September 2000 to May 2001 in the Ogden IRS Center. The audit was conducted in accordance with *Government Auditing*

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

Personal Service Corporations that Are Not Complying With the Flat Tax Rate Should be Identified

Standards. Details of our audit objectives, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Personal service corporations, because of the flat tax rate, pay significantly more tax on the first \$50,000 of taxable income than a regular corporation pays. The 35 percent rate results in \$10,000 more tax than the 15 percent graduated rate bracket a regular corporation pays. Similarly, a personal service corporation will pay \$12,750 more than a regular corporation on \$100,000 of taxable income. This additional tax affect is not completely eliminated by the graduated brackets until the personal service corporation has \$18.3 million in taxable income. After that, they both pay at the same 35 percent overall rate.

Because of this, the IRS should identify personal service corporations that may have incorrectly filed and paid taxes as regular corporations. Section 11 of the Internal Revenue Code¹ requires taxpayers that qualify as personal service corporations to file as such. However, the IRS currently does not have a process to identify and correctly process personal service corporation returns if taxpayers do not indicate that they are a personal service corporation.

Using a computer program, we identified 196,280 Tax Year (TY) 1999 U.S. Corporation Income Tax Returns (Forms 1120 and 1120A) on the IRS' Business Returns Transaction File (BRTF)¹ with principal business activity codes that we determined to be qualifying personal service industries, but the IRS had not processed them as personal service corporations. We reviewed a statistical sample of 75 of these returns and found that 16 should have filed as personal service corporations. Many taxpayers that should have filed as personal service corporations in TY 1999, but did not, had filed as personal service corporations in one or both of the preceding two years. Based on this sample, we

¹ Internal Revenue Code, 26 U.S.C. § 11(b)(2) (1994 & Supp. IV 1998).

¹ The BRTF contains information from tax returns filed for the current and two previous years.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

estimate that approximately 10,400 personal service corporations with taxable income did not file as required in TY 1999. We also estimate that these taxpayers underpaid their TY 1999 taxes by over \$15 million.

Recommendations

The Directors of Customer Accounts Services and Compliance, Small Business/Self-Employed (SB/SE) Division, should coordinate to:

1. Implement a process to identify taxpayers that are likely personal service corporations but did not file as such. For example, the IRS should identify returns by specific principal business activity codes related to personal service industries that had taxable income but calculated their tax at a rate other than 35 percent. The IRS should issue educational notices to these taxpayers regarding their potential classification as personal service corporations and suggest they file amended returns if that situation is properly applicable.
2. Identify, based on a predetermined level of potential tax revenue, and work higher dollar cases when taxpayers do not respond to the educational notices or file amended returns.

Management's Response: Management's response was due on September 24, 2001. As of September 25, 2001, management had not responded to the draft report.

The Internal Revenue Service Needs to Ensure Accurate Personal Service Data Is Entered on Tax Returns and Input to Its Computers

Taxpayers indicate if they are a personal service corporation by checking one or two boxes on their Forms 1120 or 1120A. The first box is on the front page of the forms in the upper left corner and indicates, among other things, that the corporation provides personal services as defined in the tax regulations and is subject to calendar year filing requirements. The second box, which indicates that the personal service corporation is subject to the 35 percent tax rate, is on the tax computation portion of the forms. IRS employees are responsible for placing the proper codes on the returns and accurately entering them into the computer

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

system when taxpayers have checked one or both of these boxes.³

Taxpayers do not always properly check both indicator boxes when they should

Using a computer program, we identified 143,644 TY 1999 Forms 1120 and 1120A on the BRTF for which IRS records indicated one or both of the personal service corporation boxes were checked. Of these tax returns, 22,286 indicated only one box checked. We reviewed a statistical sample of 153 of these returns. In 91 cases, taxpayers appeared to meet both requirements and should have checked both boxes, but did not. We also found 22 taxpayers that did not appear to meet the personal service corporation criteria and should not have checked either box. In the remaining 40 cases, taxpayers appear to have made the correct entries on the tax returns.

Taxpayers and practitioners appear to be confused as to which of the boxes they should check. Instructions for the box on the front page of the return tell taxpayers to “check if a personal service corp. (as defined in Temporary Regs. sec 1.441-4T-see instructions).” Some taxpayers that are in the business of providing personal services, but services that are not in fields that qualify them as personal service corporations, apparently believe this applies to them and are checking the box in error. Inaccuracies related to this box can cause tax returns to be rejected by IRS computers and result in processing delays.

Some taxpayers did not have any taxable income and simply did not complete the tax computation portion of the return, including checking the box to indicate they were a qualified personal service corporation. If the taxpayers leave this box blank and the IRS discovers errors on their tax returns that increase their taxable income, IRS computers will calculate the tax at the regular graduated rate rather than the flat

³ The IRS' Document Perfection function identifies when taxpayers check the boxes indicating they are personal service corporations. When taxpayers check these boxes, Document Perfection function employees enter specific codes on the tax returns that are to be input to IRS computers by employees in the Data Conversion function.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

35 percent rate. Later, if the IRS discovers this tax rate error, taxpayers will be billed for not only the additional tax, but also for applicable interest. Requiring taxpayers to mark more than one box to indicate that they are a personal service corporation may confuse them, even though the boxes represent two different tax situations.

IRS employees did not always properly process personal service corporation returns

Of the 153 cases above, we found 49 returns were incorrectly processed.⁴ IRS employees either did not code the returns correctly or did not accurately enter the codes into the IRS' computer system.

IRS employees process significantly fewer personal service corporation returns than regular corporate returns and may overlook these indicators.

Without accurate personal service corporation indicators, the IRS cannot correctly identify and process these returns

We estimate, based on our sample results, that taxpayers had incorrectly checked (or not checked) the personal service corporation indicator boxes on approximately 16,700 returns nationwide. Also, we estimate that there were about 6,400 returns for which the IRS made errors in processing the indicator box information. These errors could cause the IRS' computer system to contain inaccurate, or no, personal service corporation indicators for these tax returns. In certain instances discussed above and later in this report, the IRS will compute tax at the incorrect tax rate.

Recommendations

3. The Director, Tax Forms and Publications, Wage and Investment Division, should make changes related to the personal service corporation check boxes on Forms 1120 and 1120A to stress to taxpayers the importance of properly checking their personal service corporation

⁴ The total taxpayer and IRS errors exceed 153 because some cases had errors by both taxpayers and the IRS.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

status. Instructions and/or descriptions on the form should stress the purpose for each box and tax impact of the box related to the 35 percent flat tax rate. Some indication should be made to emphasize that the box on the tax schedule should be checked, if applicable, **even if there is no taxable income**.

4. The Director, Customer Accounts Services, SB/SE Division, should stress the importance of following existing processing instructions for smaller volume business return programs during training that is being conducted as the IRS consolidates the processing of business returns to two centers. This training should emphasize processing procedures and instructions for personal service corporation returns, the importance of the indicators, and the impact they have on the processing of returns.

Manual Procedures Could be Replaced With More Reliable Automated Processes

IRS computers are programmed to calculate the personal service corporation tax at the 35 percent flat rate only if the return is processed with an entry to indicate the box on the tax portion of the Form 1120 or 1120A has been checked.

When the taxpayer has computed the tax at the 35 percent flat rate but the IRS has not entered the related tax computation box into its computer records (i.e., either the taxpayer did not check the box or the IRS did not process the box correctly), the return is routed to the Error Resolution function. The IRS instructs employees to correct the problem by entering the tax computation box indicator into the computer. This will make the IRS' computer system accept the 35 percent tax computation.

This manual process is subject to human error. During our case reviews, we identified situations where taxpayers had computed the correct 35 percent tax and their returns were processed with the required box not checked. One taxpayer that had correctly computed and paid his tax at the 35 percent rate for personal service corporations had his tax reduced to regular corporation rates by the IRS. The IRS erroneously adjusted this taxpayer's account for over \$4,700. If IRS computers were programmed to accept returns computed using the flat tax rate instead of routing

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

them for manual review, these types of errors could be prevented.

The total dollars saved by the IRS or the number of times this occurs may not be significant. However, the fact that the IRS is incorrectly reducing the tax rate of taxpayers who correctly file using personal service corporation tax rates undermines the credibility of the IRS, particularly since the IRS issued a statement in 1997 cautioning practitioners and taxpayers to use the personal service corporation tax rate.

Recommendation

5. The Director, Customer Accounts Services, SB/SE Division, should revise computer programming to accept taxpayers' tax computations when they file using the 35 percent flat rate. This would mirror the intended Error Resolution results and eliminate the risk of human error.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to:

- Evaluate the Internal Revenue Service's (IRS) efforts to help taxpayers comply with filing requirements for personal service corporation income tax returns.
- Determine if the IRS correctly processed personal service corporation income tax returns.
- Evaluate taxpayers' abilities to comply with the tax laws related to personal service corporations.

To accomplish our objectives we did the following:

- I. Determined if the IRS had an effective process in place to identify, control, and correct return processing related problems for personal service corporation income tax returns.
 - A. Identified and evaluated information and controls in place within the Submission Processing function for issues related to personal service corporations.
 1. Reviewed Internal Revenue Manual (IRM) instructions and local procedures used by the Document Perfection and Data Conversion functions for identifying and processing personal service corporation returns.
 2. Interviewed managers, analysts, and employees within the Document Perfection and Data Conversion functions and discussed if they were experiencing any problems or had any concerns with the processing of personal service corporation returns.
 3. Evaluated controls to determine if they were effective to accurately identify and process personal service corporation returns.
 - B. Identified and evaluated Error Resolution System information and controls in place to identify and correct errors related to personal service corporations.
 1. Reviewed IRM instructions and local procedures, error codes, math error taxpayer notice codes, and error explanations related to issues for personal service corporation returns.
 2. Determined if the error explanations to be used for math error notice codes clearly explained the error to the taxpayer.
 3. Interviewed managers and employees within the Error Resolution function and discussed if they were experiencing any problems or had any concerns with the processing of personal service corporation returns.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

4. Evaluated controls to determine if they were effective to accurately identify and correct processing errors for personal service corporation returns.
- C. Identified and evaluated controls in place nationally within the Submission Processing function to identify, control, and correct processing related personal service corporation problems.
1. Determined if any national procedures or instructions existed to identify and process personal service corporation returns.
 2. Periodically reviewed the IRS' Submission Processing web page to identify issues or problems raised through information alerts, hot topics, or IRM correction requests that related to personal service corporations. Evaluated and determined if solutions given were effective to accurately identify and process personal service corporation returns.
 3. Reviewed the functional specification package for U.S. Corporation Income Tax Return (Form 1120 or 1120A) processing to determine if programming to calculate the personal service corporation tax rate and identify and process personal service corporation returns was accurate.
- II. Determined if the IRS correctly and properly processed corporate income tax returns with personal service corporation issues. We also evaluated taxpayers' abilities to comply with the tax law for personal service corporations in order to accurately file income tax returns.
- A. Determined if returns filed with personal service corporation indicators were accurately identified and processed by the IRS and accurately filed by taxpayers.
1. Identified from the IRS' Business Returns Transaction File¹ (BRTF) 143,644 returns for Tax Year (TY) 1999 processed with one or both personal service indicators. We stratified our population into 121,358 returns with both indicators and 22, 286 returns with only one personal service corporation indicator (16,634 with only the first box and 5,652 with only the second box). We verified that all return information was accurate by comparing the data on 10 returns against information on the IRS' records. Because our preliminary research indicated that returns with only one indicator may contain an error, we selected samples of these cases.
 2. Reviewed a statistical sample of 73 of the 16,634 returns processed with the first box indicator and without the second box indicator. Our sample was based on a 95 percent confidence level, a precision of +/- 5 percent and an expected error rate of 5 percent. We adjusted our precision to +/- 10 percent

¹ The BRTF contains information from tax returns filed for the current and two previous years.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

based on the actual error rate in our sample. We determined if the taxpayer was a personal service corporation, the IRS processed the return correctly and computed the correct tax using the correct tax rate, and the taxpayer accurately filed the return and computed the correct tax using the correct tax rate.

3. Reviewed a statistical sample of 80 of the 5,652 returns processed with the second box indicator and without the first box indicator. Our sample was based on a 95 percent confidence level, a precision of +/- 5 percent and an expected error rate of 5 percent. We adjusted our precision to +/- 10 percent based on the actual error rate in our sample. We determined if the taxpayer was a personal service corporation, the IRS processed the return correctly and computed the correct tax using the correct tax rate, and the taxpayer accurately filed the return and computed the correct tax using the correct tax rate.
- B. Determined if returns of taxpayers that quit filing as personal service corporations were accurately identified and processed by the IRS and accurately filed by taxpayers.
1. Identified from the IRS' BRTF 15,365 returns for TY 1999 that were processed without personal service corporation indicators but that had previously filed as personal service corporations (8,023 had filed as personal service corporations in both of the two preceding years and 7,342 had filed as personal service corporations in one of the preceding years). We verified that all return information was accurate by comparing the data on 10 returns against information on the IRS' records.
 2. Reviewed a judgmental sample of 73 returns for taxpayers that had filed as personal service corporations in both of the preceding 2 years and determined if the taxpayer was a personal service corporation, the IRS processed the return correctly and computed the correct tax using the correct tax rate, and the taxpayer accurately filed the return and computed the correct tax using the correct tax rate. We selected the cases at random, but did not project the results of this sample and the sample in step II.B.3 over the entire population because they could have contained some of the same cases as our sample of 75 cases discussed in step II.C.2. However, we used these judgmental samples to substantiate our statement on page 2 that many taxpayers that should have filed as personal service corporations in TY 1999, but did not, had filed as personal service corporations in one or both of the preceding 2 years.
 3. Reviewed a judgmental sample of 73 returns for taxpayers that had previously filed as personal service corporations in only 1 of the preceding 2 years and

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

determined if the taxpayer was a personal service corporation, the IRS processed the return correctly and computed the correct tax using the correct tax rate, and the taxpayer accurately filed the return and computed the correct tax using the correct tax rate.

4. Performed a computer analysis of our extract of returns to identify any trends for taxpayer filing habits or problem areas related to personal service corporation issues.
- C. Determined if returns filed with business activity codes for personal service industries were accurately identified and processed by the IRS and accurately filed by taxpayers.
1. Identified from the IRS' BRTF 196,280 returns with personal service business activity codes for TY 1999 processed without a personal service corporation indicator. We verified that all return information was accurate by comparing the data on 10 returns against information on the IRS' records.
 2. Reviewed a statistical sample of 75 returns that were not processed as personal service corporations and determined if the taxpayer was a personal service corporation, the IRS processed the return correctly and computed the correct tax using the correct tax rate, and the taxpayer accurately filed the return and computed the correct tax using the correct tax rate. Our sample was based on a 95 percent confidence level, a precision of +/- 5 percent and an expected error rate of 5 percent. We adjusted our precision to +/- 10 percent based on the actual error rate in our sample.
 3. Performed a computer analysis of our extract of returns to identify any trends for taxpayer filing habits or problem areas related to personal service corporation issues.

**Opportunities Exist to More Effectively Process
Personal Service Corporation Income Tax Returns**

Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Richard J. Dagliolo, Director

Kyle R. Andersen, Audit Manager

Kyle D. Bambrough, Senior Auditor

Scott D. Critchlow, Senior Auditor

Greg A. Schmidt, Senior Auditor

L. Jeff Anderson, Auditor

Layne D. Powell, Computer Specialist

**Opportunities Exist to More Effectively Process
Personal Service Corporation Income Tax Returns**

Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Wage and Investment Division W
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Customer Accounts Services, Small Business/Self-Employed Division S: CAS
Director, Tax Forms and Publications, Wage and Investment Division W:CAR:MP:FP
Chief Counsel CC
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M

Audit Liaisons:

Commissioner, Small Business/Self-Employed Division S:C
Commissioner, Wage and Investment Division W:C
Director, Compliance, Small Business/Self-Employed Division W:CP
Director, Customer Accounts Services, Small Business/Self-Employed Division S: CAS
Director, Tax Forms and Publications, Wage and Investment Division W:FS:S:X

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

Appendix IV

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.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$78,158,695 in additional taxes for 10,468 taxpayers (see page 2).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The Treasury Inspector General for Tax Administration (TIGTA) Information Technology staff provided a database of all Tax Year (TY) 1999 U.S. Corporation Income Tax Returns (Forms 1120 and 1120A) from the Internal Revenue Service's (IRS) Business Returns Transaction File (BRTF)¹ with business activity codes that we determined were potential qualifying personal service industries. We identified 196,280 of these corporation income tax returns that were processed without any personal service corporation indicator codes. We selected a statistically valid sample of 75 returns at a 95 percent confidence level (+/- 10 percent) using a random sampling program created with Access software. We obtained tax returns and reviewed them to determine if taxpayers appeared to qualify as personal service corporations, the IRS correctly processed the returns and computed income taxes at the correct rate, and taxpayers correctly filed the returns and computed taxes at the correct rate.

Sample Results -

We determined that 16 of the 75 taxpayers should have filed as qualified personal service corporations. Taxpayers incorrectly filed 15 returns and underpaid \$5,973 in income taxes. The remaining taxpayer filed the return correctly but the IRS processed it incorrectly.

Projection of Sample Results -

\$78,158,695 - Additional Taxes To Be Assessed by the IRS - In our sample of 75 cases, we found that income taxes were underpaid by \$5,973. Using the average dollar error of the sample, we estimated that there was a total of \$15,631,739 in underpaid income tax in our population of returns (\$5,973 divided by 75, multiplied by the population of 196,280). This amount was projected over 5 years.

¹ The BRTF contains information from tax returns filed for the current and two previous years.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

10,468 - Taxpayers Filing Incorrect Returns - In our sample of 75 cases, we found that there were 15 returns incorrectly filed by taxpayers, but only 4 of these returns had taxable income. Using the same percentage of occurrence, we estimated that there were 10,468 taxpayers with taxable income in our population of returns that may not be filing as required (4 divided by 75, multiplied by the population of 196,280).

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 83,935 returns with taxpayer errors (see page 3).
- Reliability of Information – Potential; 32,245 returns with IRS processing errors (see page 3).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

The TIGTA Information Technology staff computer identified all TY 1999 Forms 1120 and 1120A from the IRS' BRTF that were processed with personal service corporation indicators. We identified 143,644 corporation income tax returns that were processed with one or both personal service corporation indicators. From these returns, we identified 22,286 tax returns with only one indicator on IRS computer records (16,634 returns with only the first box indicator, and 5,652 returns with only the second box indicator).

From the returns with the first box indicator and without the second box indicator, we selected a statistically valid sample of 73 returns at a 95 percent confidence level (+/- 10 percent) using a random sampling program created with Access software. From the returns with the second box indicator and without the first box indicator, we selected a statistically valid sample of 80 returns at a 95 percent confidence level (+/- 10 percent) using a random sampling program created with Access software. We reviewed tax returns to determine if taxpayers appeared to qualify as personal service corporations, the IRS correctly processed the returns and computed income taxes at the correct rate, and taxpayers correctly filed the returns and computed taxes at the correct rate.

Combined Sample Results -

We secured and reviewed 153 returns and found that 113 (56 without the second box indicator and 57 without the first box indicator) taxpayers did not file their return correctly. These included 22 (12 and 10, respectively) that did not appear to meet the personal service corporation criteria but checked one or more boxes.

Of these 153 returns, we found that the IRS made processing errors on 49 returns (19 without the second box indicator and 30 without the first box indicator). The errors involved inaccurate coding or entering of data into IRS computers.

Opportunities Exist to More Effectively Process Personal Service Corporation Income Tax Returns

Projection of Sample Results -

83,935 – Returns with taxpayer errors - In our sample of 153 cases, there were 113 (56 and 57, respectively) returns that taxpayers incorrectly filed. Using the same percentage of occurrence for each sample and population, we estimated that there were a total of 16,787 taxpayers in our populations of returns that may be filing in error (56 divided by 73, multiplied by the population of 16,634; and 57 divided by 80, multiplied by the population of 5,652). This number was projected over 5 years.

32,245 - Returns with IRS processing errors - In our sample of 153 cases, there were 49 (19 and 30, respectively) returns on which the IRS made processing errors. Using the same percentage of occurrence for each sample and population, we estimated that there were a total of 6,449 returns in our populations that the IRS may be processing in error (19 divided by 73, multiplied by the population of 16,634; and 30 divided by 80, multiplied by the population of 5,652). This number was projected over 5 years.