

SPECIAL Report



NATIONAL ROOFING CONTRACTORS ASSOCIATION

January, 2001

Dear Member:

We have been notified that more than 2,000 small U.S. corporations may have overpaid their taxes due to an unawareness or misunderstanding of the small-corporation exemption from the alternative minimum tax (AMT). For the 1998 tax year, small-corporate taxpayers may have overpaid the Federal government by more than \$25 million.

The Internal Revenue Code generally exempts small corporations from the AMT if they meet certain gross receipt tests. A corporation initially qualifies for the exemption if its average gross receipts were \$5 million or less during its first three taxable years beginning after December 1, 1993. Thereafter, a small corporation can continue to qualify for the AMT exemption for so long as its average gross receipts for the prior three-year period do not exceed \$7.5 million.

We have enclosed a copy of a report issued by the Treasury Inspector General for Tax Administration that explains the situation in more detail. The report's conclusions are troubling, however, because affected small-corporate taxpayers will only receive a refund if they realize their mistake and file an amended tax return.

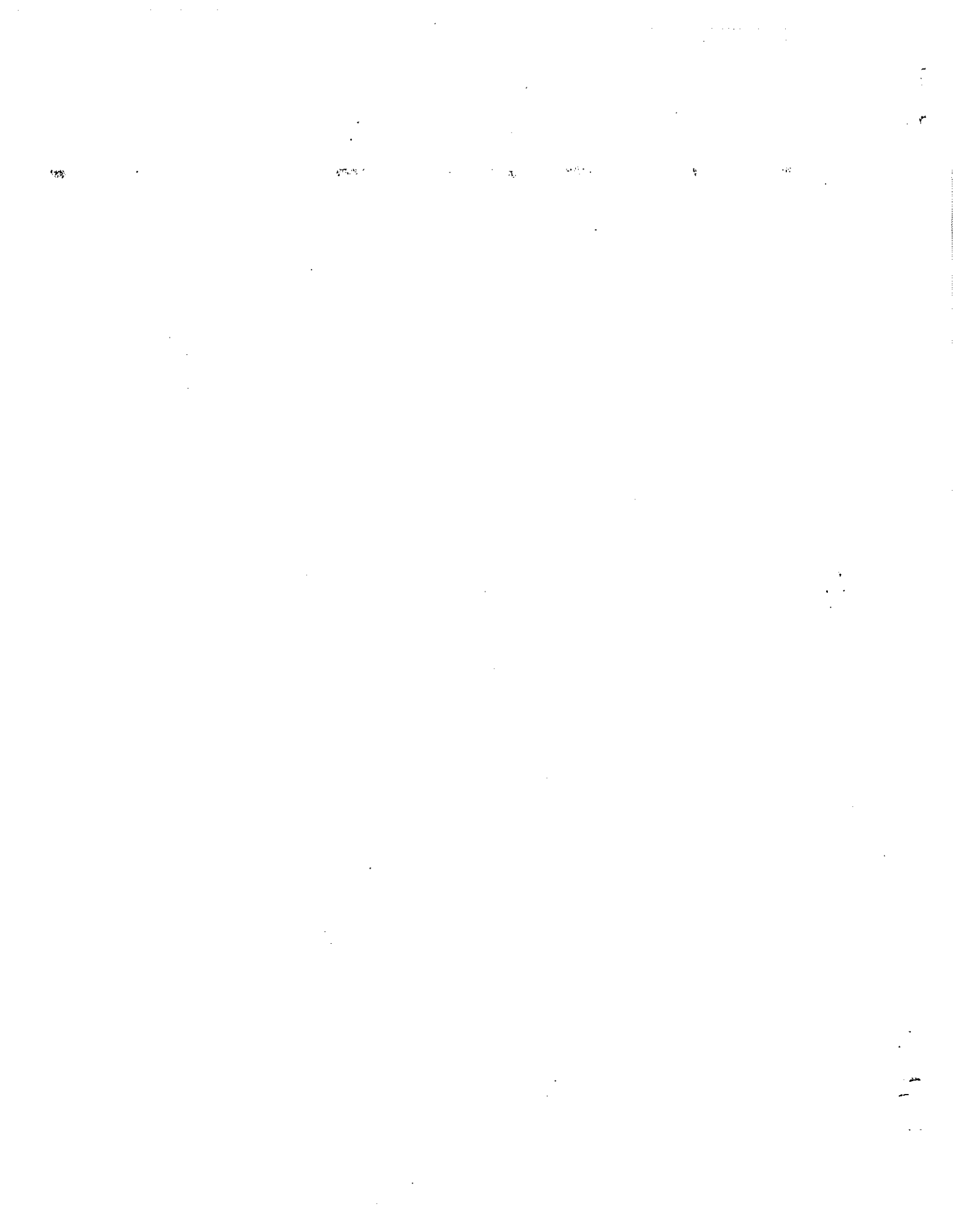
We encourage all members who may qualify for the AMT exemption to consult with your accountants or tax attorneys to be sure you did not overpay.

We offer special thanks to Sen. Christopher Bond (R-MO), chairman of the Senate Small Business Committee, for bringing this matter to our attention.

Sincerely,

A handwritten signature in cursive script that reads 'Bill Good'.

William A. Good, CAE
Executive Vice President



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

November 2000

Reference Number: 2001-30-019

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.

1

2

3

4

5

6

7

8

9

10



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

November 24, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

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.

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

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.

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

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.

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

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.

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

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.

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

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

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

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

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

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 1996¹ extended the research tax credit for the period July 1, 1996, through May 31, 1997.

The Taxpayer Relief Act of 1997² extended the credit for 13 months, from the period June 1, 1997, through June 30, 1998. The Tax and Trade Relief Extension Act of 1998³ 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.

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

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.

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

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

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

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