

**1. Please provide a written explanation of the methodology used to estimate the corporate tax gap, including any compliance rate estimates and audit issues identified while compiling this estimate.**

The corporate tax gap estimates for tax year (TY) 2006 are estimates of the overall level of compliance with the corporate income tax based on overall recommended tax adjustment data from the IRS's corporate tax return audit process; they are not based on statistically sampled audits conducted through the National Research Program (NRP). The NRP is an examination program conducted in a manner that allows the audit results from returns examined under the program to be generalized to the population from which the returns were selected, and provides the IRS with a better understanding of overall compliance than non-NRP audits. In particular, audits conducted through the NRP are broader in scope and selected to be representative of the filing population, whereas the corporate audits are typically limited in scope and selected according to the risk for noncompliance. The limited scope and selection criteria for non-NRP audits such as those used to estimate the corporate tax gap introduce statistical bias. That is, the corporate audit issues and results are not necessarily representative of the overall corporate return population.

The IRS developed methodologies to reduce the corporate tax gap estimate bias attributable to the fact that corporate audits are selected based on compliance risk, but the methodologies do not address the bias attributable to the limited scope of the corporate audits. Therefore, the IRS does not have estimates of the contribution of the major corporate audit issues to the corporate tax gap. However, response to question 3 below lists the top large corporation audit issues identified in recent fiscal years through the large corporation audit process, along with the total aggregate adjustments in each year. In future research, the IRS plans to analyze whether recent improvements in the collection of audit issue data for corporations will allow that data to inform the compliance estimation of the general corporate population on an issue-by-issue basis.

The IRS used different methods to estimate the TY 2006 underreporting tax gap attributable to small corporations (corporations reporting assets of less than \$10 million or not reporting a balance sheet) and large corporations (corporations reporting assets of \$10 million or more). For small corporations, the IRS used a yield curve model in which tax change is a function of audit coverage, allowing the IRS to estimate the amount of noncompliance IRS auditors would detect were they to audit all corporations. The IRS supplemented and evaluated this yield curve estimation with a second estimation method, an econometric model that adjusted for the fact that the IRS does not randomly select corporate audits, but rather selects them based on compliance risk. The econometric model used TY 2004 data from both audited and unaudited corporations to estimate overall small corporation compliance rates. The IRS then applied these estimated compliance rates to TY 2006 reported tax to estimate the small corporation tax gap. The estimate from the econometric method produced an estimate similar to that produced by the yield curve method.

The methodology the IRS adopted for large corporations incorporated IRS experience suggesting that the majority of large corporation underreporting is concentrated in a relatively small number of firms. The IRS used the observed underreporting of the firms with the largest recommended tax change for TYs 1998 to 2002 to project the total amount of large corporation underreporting for those years. The aggregate voluntary reporting compliance rate from that period was then applied to TY 2006 reported tax liabilities of all large corporations to estimate the TY 2006 large corporation underreporting tax gap.

A more detailed explanation of the TY 2006 methodology is described in *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation*, a copy of which is attached, and is also available at [www.irs.gov/pub/irs-soi/06rastg12workppr.pdf](http://www.irs.gov/pub/irs-soi/06rastg12workppr.pdf).

The following tables show the corporate income tax gap and voluntary compliance rate estimates for TYs 2001 and 2006.

**Corporation Income Tax Underreporting Gap<sup>1</sup>**

	TY2001	TY2006
<b>Total (\$billions)</b>	<b>30</b>	<b>67</b>
Small Corporations (Assets under \$10M)	5	19
Large Corporations (Assets over \$10M)	25	48

<sup>1</sup> Excerpted from *TY 2006 Tax Gap Estimate --Summary of Methods, January 2012*, a copy of which is attached, and is also available at [www.irs.gov/pub/newsroom/summary\\_of\\_methods\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/summary_of_methods_tax_gap_2006.pdf).

**Voluntary Compliance Rates and Liability Shares:  
Tax Year 2001 vs. Tax Year 2006<sup>2</sup>**

Tax Gap Component	Voluntary Compliance Rates		Distribution of Liability	
	TY2001	TY2006	TY2001	TY2006
Overall (all taxes combined)	83.7%	83.1%	100%	100%
Individual Income Tax	79%	77%	54%	48%
Corporation Income Tax	82%	82%	8%	15%
Employment Tax	92%	91%	33%	33%
Estate Tax	77%	74%	2%	1%
Excise Tax	N/A	N/A	3%	2%

*Note: The Voluntary Compliance Rates reflect all three types of noncompliance: Nonfiling, underreporting, and underpayment.*

<sup>2</sup> Excerpted from *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation*, a copy of which is attached, and is also available at [www.irs.gov/pub/irs-soi/06rastg12workppr.pdf](http://www.irs.gov/pub/irs-soi/06rastg12workppr.pdf).

**2. Does the IRS maintain a centralized repository of corporate audit issues resulting in adjustments? If not, why not and what are the obstacles to creating this database? If so, how frequently is this information updated, how is this information collected, and what IRS divisions have access to this database?**

The IRS operating divisions that audit corporate income tax have systems that track adjustments by issue using information from IRS corporate audits, although there are variations in the types of information collected in each system. The IRS Large Business & International (LB&I) division is the business unit responsible for auditing businesses with assets of \$10 million or more. The IRS Small Business/Self-Employed (SB/SE) division is responsible for smaller businesses. LB&I and SBSE have different systems that track adjustments by issue. LB&I's Issue Management System provides more detailed identifying information about the issue that resulted in an adjustment. The top LB&I audit issues and aggregate adjustments are described below in response to question 3. At this time, it would be too costly to change SB/SE's system to track the same information as LB&I. However, the IRS is planning to develop and implement an enterprise-wide case management system as funding permits, whose long-term capabilities will enable the IRS to generate statistics on aggregate adjustments for the top SB/SE issues. A list of some of the top SB/SE issues is provided in response to question 3, although it is not possible at this time to provide statistics on aggregate adjustments. LB&I's and SB/SE's systems are continually updated as cases are closed, and IRS operating divisions and the IRS Research, Analysis, and Statistics (RAS) division have access to the systems.

**3. Please provide a list of the top corporate audit issues and the most common adjustments made on audit. Please include an estimate of the contribution each of these issues makes toward the corporate tax gap.**

Below is a list of the largest common adjustments made during corporate audits conducted by LB&I, followed by a list of issues commonly resulting in adjustments in smaller corporate audits SB/SE conducts. As described in response to question 1 above, the TY 2006 corporate tax gap estimates for both small and large corporations are based on the overall recommended tax adjustment of the historical audit data and not on the specific issues that were addressed on those audits. Therefore, the IRS methodologies for the TY 2006 corporate tax gap do not incorporate an analysis of the contribution of each discrete corporate issue (for example, Subpart F) to the overall corporate tax gap. The IRS can, however, provide the total aggregate adjustments for each of the LB&I issues during the past three years. In future research, the IRS plans to analyze whether recent improvements in the collection of corporate audit issue data allow estimation of each issue's contribution to the overall corporate tax gap.

## LB&I Issues

### 1. IRC Section 482 – Transfer Pricing

Under the transfer pricing rules of Internal Revenue Code (IRC) section 482, the IRS may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among commonly controlled corporations to prevent evasion of taxes or to clearly reflect a corporation's income. Common section 482 adjustments relate to inter-company transfers (or licenses) of intangibles, as well as other intercompany transactions such as the sale of goods, the provision of services, the use of tangible assets, the provision of trade credit, and the intercompany allocation of business expenses.

<b>IRC § 482 – Transfer Pricing</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	268	251	129
Total Adjustment Amount	\$6,888,150,635	\$16,962,834,027	\$5,017,116,293

### 2. IRC Section 199 – Domestic Production Deduction

IRS examiners adjust the numerous components included in the computation of the section 199 domestic production deduction, especially Domestic Production Gross Receipts (DPGR) and Cost of Goods Sold (COGS), which are used to determine Qualified Production Activities Income (QPAI), a critical component in determining the amount of deduction a taxpayer may claim. In addition, the IRS has also adjusted Qualified Production Activity Expenses (QPAE) and Allocable W-2 Wages, which are also used in the computing the deduction.

<b>IRC § 199 - Domestic Production Deduction</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	406	458	511
Total Adjustment Amount	\$2,517,363,666	\$2,379,125,920	\$10,649,968,715

### 3. Subpart F Issues

Subpart F of the IRC (sections 951 through 956) contains rules for controlled foreign corporations, and provides for additional income inclusions ("Subpart F income") for certain types of income earned through foreign corporations. Adjustments the IRS makes in this area relate to ensuring that the numerous types of Subpart F income are properly accounted for.

<b>Subpart F Issues</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	85	70	29
Total Adjustment Amount	\$1,861,614,888	\$1,129,311,723	\$3,713,586,907

### 4. IRC Section 162 – Business Expense Deduction

Section 162 provides a deduction for business expenses, and is one of the most widely-used authorities for claiming deductions. The adjustments IRS examiners make cover a range of industries and subjects.

<b>IRC § 162 - Business Expense Deduction</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	1589	529	425
Total Adjustment Amount	\$670,727,855	\$1,142,228,639	\$1,275,521,088

### 5. Foreign Tax Credits

The IRC allows taxpayers a credit against their U.S. tax liability for certain foreign taxes paid. The adjustments the IRS makes in this area primarily relate to:

- Whether foreign taxes are creditable (for example, whether the foreign tax is an income tax, whether payment is compulsory, or whether the taxpayer is legally liable);
- Transactions where foreign taxes are separated from their underlying earnings;
- Earnings and profits of foreign subsidiaries which generate the foreign taxes;
- Transactions involving planning under
  - The expense allocation and apportionment rules of Treas. Reg. section 1.861-8, and
  - The various character and source rules of the IRC, the regulations, and judicial authorities.

<b>Foreign Tax Credits</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	410	248	104
Total Adjustment Amount	\$6,710,054,710	\$1,701,343,821	\$609,155,588

## 6. IRC Section 41 – Credit for Increasing Research Activities

Internal Revenue Code section 41 provides a credit for increasing certain research activities. Many of the adjustments on this issue are related to the determination of Qualified Research Expenses (QRE), a key element in the calculation of the credit.

<b>IRC § 41 - Credit for Increasing Research Activities</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	691	611	682
Total Adjustment Amount	\$652,860,364	\$604,078,225	\$410,303,272

## 7. Repatriation Issues

Certain income earned through foreign corporations is not taxed until brought back to the United States. Taxpayers use a variety of techniques to attempt to economically bring foreign earnings into the United States without triggering a taxable repatriation, and the IRS commonly challenges these techniques. Common issues in this area include:

- Section 956 – which addresses various disguised distributions,
- Killer “B” Transactions (including triangular asset reorganizations),
- “All Cash D” and “Deadly D” reorganizations,
- Basis plays using “Outbound F” reorganizations,
- Section 304(a)(1) Distributions – Affirmative Uses of § 304, and
- Section 304(a)(2) Distributions – “Sandwich section 304” – Stripping of the earnings and profits of controlled foreign corporations.

<b>Repatriation Issues</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	50	36	18
Total Adjustment Amount	\$980,659,805	\$1,502,699,887	\$120,457,509



## 8. Inbound Financing

Adjustments the IRS makes in this area involve arrangements of foreign-based taxpayers to finance U.S. operations without incurring U.S. tax. Common financing structures include:

- Loans into the United States through financing affiliates organized in low-tax jurisdictions,
- Foreign guarantees of U.S. affiliates' debt, and
- Cash-less debt transferred to the United States.

<b>Inbound Financing Issues</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	9	26	7
Total Adjustment Amount	\$499,414,277	\$712,349,958	\$382,324,385

## 9. Withholding Taxes for International Transactions

The IRC imposes several withholding tax regimes designed to ensure that income earned is properly taxed when sent offshore. Adjustments the IRS makes in this area involve common transactions and structures used to take income and earnings from a foreign taxpayer's U.S. investments offshore without incurring U.S. withholding taxes on the expatriation of the income. Common adjustments involve the following issues:

- Section 884 – Branch Taxes: Branch Profits Tax (BPT) and Branch Level Interest Tax (BLIT),
- Section 1441/1442 – Withholding Tax on Noneffectively Connected Income,
- Section 1445 – Withholding Tax on a Disposition of a U.S. Real Property Interest,
- Section 1446 – Withholding Tax on a Foreign Partner's Effectively Connected Income, and
- Income tax treaties and the repatriation and withholding tax rules.

<b>Withholding Tax Issues</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	35	74	33
Total Adjustment Amount	\$155,157,047	\$849,416,831	\$39,381,732

#### 10. IRC Section 461 – Proper Taxable Year for Deduction

IRC section 461 provides the general rule for the taxable year of a deduction. The IRS frequently makes adjustments to this issue, including determining the proper year a taxpayer may deduct accrued bonuses to its employees.

<b>IRC § 461 - Taxable Year of Deduction</b>	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Returns with Issue Adjusted	414	442	374
Total Adjustment Amount	\$370,152,194	\$21,983,847	\$56,904,210

#### SB/SE Issues

Excessive Compensation – The IRS makes adjustments to reduce C corporations' excess compensation, reducing the corporations' salary expense deductions and increasing non-deductible dividends.

Inadequate Compensation – The IRS makes adjustments to increase S corporations' inadequate compensation, increasing income subject to employment taxes.

Shareholder Loans – The IRS makes adjustments to ensure that taxable dividends disguised as non-taxable loans are properly taxed as dividends.

Sale or Final Year of Business – The IRS makes adjustments to ensure that the disposition or dissolution of both C and S corporations are properly taxed.

Research Credit- Similar to LB&I, SB/SE makes adjustments to ensure that only qualifying expenses are taken into account in determining the research credit.

Method of Accounting – The IRS makes adjustments to ensure that both C and S corporations use consistent, appropriate, methods of accounting.



**4. Please provide a copy of any data or work papers used by the IRS to prepare the corporate tax gap estimates.**

Attached please find the following papers describing the corporation tax gap estimates, which are also available at the links below each title:

- Tax Gap for Tax Year 2006: Overview, Jan. 6, 2012  
[www.irs.gov/pub/newsroom/overview\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf)
- *TY 2006 Tax Gap Estimate --Summary of Methods, January 2012* at  
[www.irs.gov/pub/newsroom/summary\\_of\\_methods\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/summary_of_methods_tax_gap_2006.pdf)
- *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation* at  
[www.irs.gov/pub/irs-soi/06rastg12workppr.pdf](http://www.irs.gov/pub/irs-soi/06rastg12workppr.pdf)

**5. In 2006, the Treasury Office of Tax Policy released a report titled "A Comprehensive Strategy for Reducing the Tax Gap." The strategy noted "research is essential to identify sources of noncompliance so that IRS resources can be properly targeted. Regularly updating compliance research ensures that the IRS is aware of vulnerabilities as they emerge." Please describe any recent steps taken by the IRS to improve its compliance research capabilities.**

The IRS continues to improve and develop its compliance research capabilities. Since Treasury issued the 2006 strategy report, the IRS has completed or begun several studies under the NRP. As described above, the NRP is an examination program conducted in a manner that allows the audit results from returns examined under the program to be generalized to the population from which the IRS selected the returns.

Beginning with tax year 2006, the IRS has been conducting annual individual income tax studies. The studies through TY 2011 are complete, and the other studies are in various stages of completion. The IRS also conducted studies of employment tax (Form 941) for TYs 2008-2010 and excise tax (Form 720) for TYs 2012-2013, and the final perfected data sets for these studies are nearly complete.

In addition, the IRS has conducted studies of segments of the corporation population. The IRS has nearly completed a TY 2010 NRP study of small corporations with a balance sheet reporting assets less than \$250,000. The IRS is also in progress on a TY 2010-2012 NRP study of corporations with reported assets between \$10 million and \$100 million.

IRS studies into the corporate income tax include ongoing research into the value of the Form 1120 Schedules M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More) and UTP (Uncertain Tax Position Statement) for understanding corporate compliance. The goal of the Schedule M-3 is to increase corporations' reporting of adjustments (book-tax-differences) made to their books and

records in preparing their tax returns. Schedule M-3 assists the IRS in selecting returns and issues for audit by highlighting areas of tax compliance risk.

An IRS internal 2014 research study compared 2010-2011 Schedule M-3 and Form 1120 tax return data profiles for Schedule UTP filers and non-filers with \$100 million or more in assets. The study concluded that Schedule UTP does not identify the same tax compliance risks as Schedule M-3. The paper therefore concluded that Schedules UTP and M-3 are complementary and not duplicative for tax compliance risk analysis, especially given that only a minority of large corporations files a Schedule UTP while all file a Schedule M-3.

An internal 2015 research study compared the 2011-2012 Schedule M-3 and Form 1120 tax return data profiles for corporations that filed Schedule UTP filers versus corporations that did not file Schedule UTP. For Schedule UTP filers with SEC 10K financial statements and \$100 million or more in assets, the study further examined the relationship between the information reported on Schedule M-3 and the information reported on Schedule UTP. Specifically, the study examined whether corporations with particular Schedule M-3 data profiles are more likely to cite on Schedule UTP any of the top five IRC sections that taxpayers most commonly cite on Schedule UTP. The study concluded that there is a sufficiently strong relationship between the information reported on Schedule M-3 and the information reported on Schedule UTP to allow the IRS to develop models to help predict the uncertain tax positions of corporations that file Schedule M-3 but not Schedule UTP.

Finally, LB&I continually reviews and updates its research techniques and models to keep pace with changing laws, regulations, and taxpayer filing behaviors. LB&I has recently updated its corporate risk models from purely statistical to hybrid models, so as to address risk from both a statistical as well as a deterministic standpoint. The deterministic risk assessment is achieved by evaluating tax return information in reference to risk assessment filters that have been validated as having high predictability in identifying specific tax compliance issues.

Where potential high-risk tax issues are identified on a filed return, LB&I also provides its field examiners with an explanation of the issue, so they can be better prepared to understand and thoroughly investigate potential tax noncompliance. LB&I has developed a feedback mechanism that allows field examiners to provide detailed feedback on issue identification and risk assessment accuracy.

The IRS has also established an Emerging Tax Compliance Risk Working Group to improve its existing processes related to identifying emerging tax compliance issues. This group will focus on transitioning the current approaches to a more structured framework with processes for regular emerging risk scans, assessment activities, and risk mitigation response strategies in the relevant compliance work plans.