



*Billions of Dollars of Potentially Erroneous
Carryforward Claims Are Still
Not Being Addressed*

August 28, 2019

Reference Number: 2019-40-044

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Redaction Legend:

2 = Law Enforcement Techniques/ Procedures and Guidelines for Law Enforcement Investigations or Prosecutions

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HIGHLIGHTS

BILLIONS OF DOLLARS OF POTENTIALLY ERRONEOUS CARRYFORWARD CLAIMS ARE STILL NOT BEING ADDRESSED

Highlights

Final Report issued on August 28, 2019

Highlights of Reference Number: 2019-40-044 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

A “carryforward” credit or deduction refers to claiming the unused portion of a tax credit or deduction on a future year’s tax return. A credit reduces the tax liability amount, whereas a deduction reduces taxable income. About 2.5 million Tax Year (TY) 2015 tax returns contained claims for carryforward credits totaling \$81.9 billion. In addition, 6.5 million TY 2015 tax returns claimed carryforward deductions of \$55.9 billion.

WHY TIGTA DID THE AUDIT

In two previous reviews, TIGTA recommended that the IRS develop a process to ensure the accuracy of carryforward claims. This audit was initiated to determine what corrective actions the IRS has taken in response to two previous TIGTA reviews dealing with General Business Credit carryforward claims. It was also initiated to assess the effectiveness of current IRS controls to detect and prevent questionable carryforward claims on individual and business income tax returns.

WHAT TIGTA FOUND

Actions have not been taken to

TIGTA’s review of TY 2015 electronically filed returns found that taxpayers continue to claim carryforward amounts

TIGTA identified 19,193 taxpayers claiming a carryforward credit or deduction with discrepancies totaling more than \$5 billion that was used to offset tax. A discrepancy exists when a taxpayer

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In addition, processes are not in place *****2*****
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*****2*****, a concern TIGTA first reported in Calendar Year 2013. A judgmental sample of 100 tax returns identified that 63 taxpayers did not include the required statement with their TY 2015 General Business Credit carryforward claims. The IRS could use the information *****2***** to identify potentially erroneous carryforward claims.

WHAT TIGTA RECOMMENDED

TIGTA made six recommendations, including that the IRS add criteria to its risk tool to identify high-risk carryforward Research Credit claims, and also to identify and examine returns with discrepancies of General Business Credit carryforward claims. Based on the results of this work, and if warranted, expand the criteria to identify other carryforward claims with discrepancies. TIGTA also recommended that the IRS prepare and submit an information technology request *****2*****
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*****2*****.

Finally, TIGTA recommended that the IRS develop a strategy to evaluate possible revisions to tax forms to capture carryforward claim information. While the strategy is being developed, the IRS should implement an educational campaign *****2*****
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The IRS agreed with three recommendations and partially agreed with one recommendation. The IRS disagreed with the need to prepare and submit an information technology request to *****2*****

because carryforward discrepancies are not compliance issues. The IRS also disagreed with the need to change tax forms without evidence that such information would be beneficial to identifying noncompliance. While the IRS disagreed with the need for an educational campaign, *****2*****
*****2*****
*****2*****.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 28, 2019

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Billions of Dollars of Potentially Erroneous
Carryforward Claims Are Still Not Being Addressed
(Audit # 201840023)

This report presents the results of our review to assess the effectiveness of the Internal Revenue Service's (IRS) controls to detect and prevent questionable carryforward claims on individual and business income tax returns. This audit is included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management challenge of Reducing Fraudulent Claims and Improper Payments.

Management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).



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Abbreviations

e-file(d)	Electronically file(d)
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



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Background

Certain tax credits and deductions have annual limits that prevent taxpayers from deducting the full amount in a single year. For these types of credits and deductions, provisions in the tax code allow the unused amount to be carried back and/or forward (referred to as a carryforward credit/deduction) to a prior or future year’s tax return. While each credit and deduction has separate requirements, in general, the credits and deductions can be carried back one year and forward up to 20 years¹ until the full amount of the credit or deduction is taken.²

Carryforward credits

A carryforward credit reduces a taxpayer’s tax liability. Figure 1 provides the number of returns and dollar amounts associated with the different credits with carryforward claims for Tax Year (TY)³ 2015.

Figure 1: Total Carryforward Credits Claimed TY 2015

Credit Type	Taxpayer Type	Number of Tax Returns	Total Credit Claimed	Number of Carryforward Tax Returns	Total Carryforward Claimed
Form ⁴ 3800, <i>General Business Credit</i> ⁵	Business	82,609	\$22.3 billion	58,046	\$12.3 billion
	Individual	456,664	\$3.1 billion	173,035	\$1.3 billion
Forms 8801 and 8827, <i>Prior Year Minimum Tax Credit</i>	Business	14,317	\$1.7 billion	11,108	\$1.7 billion
	Individual	1.1 million	\$787.3 million	745,675	\$614 million
Forms 1116 and 1118, <i>Foreign Tax Credit</i>	Business	10,111	\$93.4 billion	4,940	\$59.2 billion
	Individual	4.3 million	\$12.6 billion	1.5 million	\$6.9 billion
Form 8912, <i>Holders of Tax Credit Bonds Credit</i>	Business	420	\$309.7 million	35	\$3.6 million
	Individual	2,552	\$5.7 million	199	\$173,541

¹ Appendix VII provides more details about the carryback and carryforward periods for the various credits and deductions.

² Appendix VI provides a list of the carryforward credits and deductions we evaluated as part of this review.

³ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁴ See Appendix VI for the titles of the forms included in this figure.

⁵ For TY 2015, there were 37 General Business Credits that could be claimed on the Form 3800.



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Credit Type	Taxpayer Type	Number of Tax Returns	Total Credit Claimed	Number of Carryforward Tax Returns	Total Carryforward Claimed
Form 8834, <i>Plug-in Electric Vehicle Credit</i>	Business	36	\$75,000	4	Unknown ⁶
	Individual	718	\$1.3 million	500	Unknown
Form 8839, <i>Adoption Credit</i>	Individual	87,103	\$300.4 million	Unknown	Unknown
Form 8396, <i>Mortgage Interest Credit</i>	Individual	72,915	\$84.9 million	9,447	\$12.6 million
Form 8859, <i>District of Columbia Homebuyer Carryover Credit</i>	Individual	763	\$1 million	733	\$1 million
Totals ⁷		6.1 million	\$134.6 billion	2.5 million	\$81.9 billion

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Individual and Business Returns Transaction Files data as of August 28, 2017.

Carryforward deductions

A carryforward deduction reduces a taxpayer’s taxable income. The deductions are similar to credits except they can be used to directly reduce future income rather than tax. Deductions not allowed to be deducted in the current year are carried back one year and forward to the next year until the initial deduction is used up. Figure 2 provides the number of deductions available and the amounts claimed in TY 2015.

⁶ The carryforward amount could not be determined because the data were not transcribed, or information was included as part of a total of several deductions and the amount attributable to this credit could not be isolated.

⁷ The totals were computed using the actual numbers, so the rounded numbers presented may not add up to the total.



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Figure 2: Total Carryforward Deductions Claimed⁸ TY 2015

Deduction Type	Taxpayer Type	Number of Tax Returns	Total Deductions Claimed	Number of Carryforward Tax Returns	Total Carryforward Deductions
Schedule A, <i>Amortizable Bond Premium Deduction</i> ⁹	Individual	Unknown	Unknown ¹⁰	Unknown	Unknown
Form 4952, <i>Investment Interest Expense Deduction</i>	Individual	1.6 million	\$13.8 billion	784,079	\$5.4 billion
Schedule D, <i>Capital Losses Deduction</i>	Individual	17.5 million	\$538.4 billion	4.4 million	\$50.1 billion
Form 8926, <i>Disqualified Interest Expense Deduction</i>	Business	4,059	\$7.4 billion	1,565	\$376.4 million
Forms 8328 and 8038, <i>Bond Volume Cap Deduction</i>	Business	265	\$1.9 billion ¹¹	36	\$1.9 billion
Forms 1120, 1040, and 1041, <i>Net Operating Loss Deduction</i>	Business	928,475	\$213 billion	866,256	Unknown
Schedule A, <i>Charitable Contributions Deduction</i>	Individual	31.9 million	\$178.7 billion	475,382	Unknown
Totals ¹²		52.1 million	\$953.2 billion	6.5 million	\$55.9 billion

Source: TIGTA analysis of Individual and Business Returns Transaction Files data as of August 28, 2017.

This review was performed with information obtained from the Large Business and International Division in Washington, D.C.; the Small Business/Self-Employed Division in Lanham, Maryland; the Large Business and International Division office in Portsmouth, New Hampshire; and the Small Business/Self-Employed office located in Fairfield, California, during the period December 2017 through February 2019. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings

⁸ The deduction amounts were claimed on the tax return by the taxpayer.

⁹ See Appendix VI for a detailed explanation of each deduction.

¹⁰ The deduction amount is included as part of a total of several deductions, and there is no way to break out a single amount.

¹¹ The carryforward amount is the same as the deduction amount due to how the deduction is reported on Forms 8328 and 8038.

¹² The totals were computed using the actual numbers, so the rounded numbers presented may not add up to the total.



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and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

Actions Have Not Been Taken to *****2*****

Our review of TY 2015 electronically filed (e-filed) returns found that taxpayers continue to claim carryforward amounts *****2*****. We identified 19,193 taxpayers claiming a carryforward credit or deduction with discrepancies totaling more than \$5 billion that was used to offset tax. A discrepancy exists when a taxpayer claims a carryforward amount *****2*****. The following hypothetical example illustrates the type of discrepancies we identified that make up the more than \$5 billion in overstated credit and deduction claims:

Taxpayer A claims a carryforward credit totaling \$1,500 on his or her TY 2014 tax return. The taxpayer has a pre-credit tax liability of \$1,000 for which \$1,000 of the carryforward credit is applied to reduce the tax to zero. Taxpayer A would show on his or her TY 2014 tax return that he or she has \$500 in unused credit remaining and available to carry forward to TY 2015. Taxpayer A files his or her *****2*****

Prior TIGTA reviews identified that the IRS *****2*****. The prior reviews identified discrepancies related to the amounts of carryforward General Business Credits claimed by both individual and business filers. For example:

- September 2013 – we identified 3,998 individual TY 2011 tax returns with General Business Credit carryforward claims totaling \$41 million for which the carryforward amounts *****2***** We recommended that the IRS *****2*****



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*****2*****
*****2*****. The IRS agreed with this recommendation.¹³

In response to our recommendation, the IRS selected and examined 1,069 returns from the 3,998 returns we identified. The IRS corresponded with the taxpayers, reviewed taxpayer responses, and closed 938 returns with no change or adjustment to the amount of carryforward credit claimed. For each of these returns, the IRS did not review the carryforward credit discrepancy to ensure that the claim was valid before closing the return as a no change. The only action taken by the IRS was to verify that a valid *****2*****. For the remaining 131 examined returns, the taxpayer either agreed with the IRS's adjustment to the carryforward credit (74), had no change with adjustments (3), petitioned for an appeal (16), or failed to respond to the IRS's letter regarding the adjustment (38).

- February 2015 – we identified 3,177 e-filed Processing Year¹⁴ 2013 business returns with General Business Credit carryforward claims totaling \$1.5 billion for which **2** *****2***** *****2***** **2**. A similar recommendation was made for the IRS to *****2***** *****2*****.

The IRS disagreed with this recommendation stating that it lacks the needed information technology resources and there were other competing priorities.¹⁵ Of the 3,177 returns that we identified with a discrepancy, the IRS reviewed only 30 taxpayers' accounts. This review did not determine whether the claim was valid. The IRS reviewed the tax account online to see if the subsequent TY 2013 return had the same issue ****2**** *****2***** (similar to their previous tax return) and based on the result, determined that there was not a compliance risk.

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Since we first raised our concerns in September 2013, the IRS has *****2***** *****2*****.

As a result, potentially erroneous claims continue to go undetected. For example, in this current review of TY 2015 e-filed returns, we found that taxpayers continue to claim carryforward amounts *****2*****

¹³ TIGTA, Ref. No. 2013-40-093, Unsupported and Potentially Erroneous Claims for General Business Credits Are Not Always Identified When Tax Returns Are Processed p. 12 (Sept. 2013).
¹⁴ The calendar year in which the tax return or document is processed by the IRS.
¹⁵ TIGTA, Ref. No. 2015-40-012, Processes Do Not Ensure That Corporations Accurately Claim Carryforward General Business Credits p. 5 (Feb. 2015).



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****2****. Figure 3 provides a breakdown of individual tax returns with discrepancies in the carryforward credits and deductions claimed, along with a stratification of the potential tax effect.¹⁶

Figure 3: Tax Effect From Individual Returns With Potentially Erroneous Carryforward Credit/Deduction Claims

Tax Effect	Potentially Erroneous Carryforward Credits and Deductions Claims			
	Returns Claiming a Potentially Erroneous Credit	Tax Effect	Returns Claiming a Potentially Erroneous Deduction	Tax Effect
\$500 to \$5,000	6,210	\$11.2 million	6,802	\$10.1 million
\$5,001 to \$10,000	1,218	\$8.6 million	706	\$4.9 million
Greater than \$10,000	1,937	\$108.6 million	886	\$59.5 million
Total	9,365	\$128.4 million	8,394	\$74.5 million

Source: TIGTA analysis of Individual Returns Transaction Files as of August 24, 2018.

Figure 4 provides a breakdown of business tax returns with discrepancies in the carryforward credits and deductions claimed, along with a stratification of the potential tax effect.

Figure 4: Tax Effect From Business Returns With Potentially Erroneous Carryforward Credit/Deduction Claims

Tax Effect	Potentially Erroneous Carryforward Credits and Deductions Claims			
	Returns Claiming a Potentially Erroneous Credit	Tax Effect	Returns Claiming a Potentially Erroneous Deduction	Tax Effect
\$500 to \$5,000	581	\$951,231	3	\$7,228
\$5,001 to \$10,000	132	\$918,154	3	\$26,133
Greater than \$10,000	710	\$4.9 billion	5	\$265,221
Total	1,423	\$4.9 billion	11	\$298,582

Source: TIGTA analysis of Business Returns Transaction Files as of August 24, 2018.

¹⁶ We determined the tax effect by calculating the discrepancy *****2***** for a specific credit or deduction. The tax effect is the lesser of the discrepancy amount or general credit claimed amount. For the deduction, we applied a marginal tax rate.



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We provided the previously mentioned discrepancy cases to IRS management for their review and discussed with IRS management *****2*****. While the IRS agreed with our analysis methodology in how we identified the returns, management stated that there are legitimate reasons why a discrepancy could exist. For example, a taxpayer could be correcting a prior year carryforward mistake or business taxpayers might acquire or merge with another business that already has available carryforward credits. Our review of the return filings associated with the top 10 discrepancy cases (based on the dollar amount of the discrepancy) found that the tax returns did not provide enough information for us to readily identify why a discrepancy exists. We agree that there could be legitimate reasons why a discrepancy exists. However, to make this determination, *****2***** apply selection criteria to determine if there is a legitimate reason why the discrepancy exists.

IRS management indicated that discrepancies with carryforward claims can be addressed when taxpayers are audited. Our analysis identified that only 3,821 (5 percent) of the 76,162 TY 2015 individual and business tax returns we identified as having a potentially erroneous carryforward credit and/or deduction claim were selected for examination. Although the 3,821 tax accounts had an examination indicator on the associated tax account, we were unable to determine if the carryforward discrepancy was in fact an issue addressed in the examination. When we raised concern about this, management noted that their current examination systems do not capture enough information to indicate that a carryforward issue was included in the examination. As a result, the IRS does not have the information needed to track and measure the compliance risk related to carryforward credit or deduction claim discrepancies.

Management is planning to include identification of carryforward claim discrepancies as part of an existing compliance project

In discussing our results with IRS management, they noted that, as part of an existing compliance project focused on Research Credit claims, they are planning to add criteria to their selection risk tool to identify high-risk General Business Credit and Research Credit carryforward claims.¹⁷ For example, management plans to *****2*****. Results from this project will be used to measure the potential compliance risk associated with carryforward

¹⁷ For example, IRS management indicated that a high-risk Research Credit carryforward claim is one in which the *****2*****. Because carryforward claims are on a first-in/first-out basis, *****2***** indicates possible use of the Research Credit in the current year.



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discrepancies and determine if additional compliance campaigns/programs¹⁸ and adjustments to current carryforward audit procedures are warranted.

Recommendations

The Commissioner, Large Business and International Division, should:

Recommendation 1: Ensure that criteria is added to the Research Credit selection risk tool to identify high-risk carryforward Research Credit discrepancy claims on returns selected for examination and determine if the carryforward claims taken by the taxpayers are accurate. Based on the results of examining these returns, determine if examination criteria should be expanded to include other carryforward claims with discrepancies.

Management's Response: The IRS agreed with this recommendation and has already added information to the risk tool on the General Business Credit carryover, which will help identify *****2***** of General Business Credit carryforwards. The risk tool will help examiners assess the scope and depth of research credit examinations on business cases selected for examination. If the risk tool indicates a high level of risk, examiners will verify research credit amounts (current, carryforward, and carryback) based on available resources. IRS management also plans to review the results of the examinations that used the risk tool. If significant risk is identified, IRS management will determine the appropriate next steps on Research Credit cases and whether similar approaches should be taken on any of the other carryforward issues.

The Commissioner, Small Business/Self-Employed Division, should:

Recommendation 2: Identify and examine returns with discrepancies of General Business Credit carryforward claims. Based on the results of examining these returns, determine if examination criteria should be expanded to include all business and individual carryforward claims containing discrepancies.

Management's Response: The IRS agreed with this recommendation and plans to use data analytics to determine the size and scope of the noncompliance of the General Business Credit carryforward for Small Business/Self-Employed Division taxpayers. IRS management also plans to initiate examinations on a statistically valid sample of returns displaying a General Business Credit carryforward discrepancy between tax years. Results of the examinations will be evaluated to determine if the presence of a discrepancy is a good indicator that material noncompliance exists and whether

¹⁸ Campaigns are used by the Large Business and International Division and involve using the appropriate resources to support the identification and evaluation of a compliance issue and a more deliberate consideration of potential treatment streams. The Small Business/Self-Employed Division identifies its areas of focus in its annual Examination Program Letter.



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examinations should be expanded to include other business and individual carryforward claims containing material discrepancies.

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should:

Recommendation 3: Prepare and submit an information technology request *****2*****
*****2*****
*****2***** selection criteria to determine if the carryforward claim is valid.

Management's Response: The IRS disagreed with this recommendation. IRS management stated that carryforward discrepancies, in and of themselves, are not compliance issues. There are legitimate reasons that discrepancies exist. The size and scope of the compliance issue, if any, has not been established. Thus, the potential benefits, if any, of such a system are unknown. Past examinations of General Business Credit carryforward discrepancies yielded high no-change rates. It could be several years before the IRS has adequate examination results from the review of the cases in Recommendations 1 and 2, let alone other carryforward issues, to determine if a compliance issue exists.

IRS management also stated that any request for an information technology investment is unsupported without a proper cost-benefit analysis. This analysis cannot be accomplished until the IRS determines if there is a compliance issue. IRS management does not know that implementation of such a system would require a significant amount of increased transcription of paper returns as well as a significant cost to its information technology programming resources.

Finally, the IRS must balance the use of its limited enforcement resources. Even if the results of future credit carryforward examinations identify noncompliance, IRS management must consider the risk of placing additional carryforward returns into the audit stream thereby potentially bypassing other returns with higher audit potential.

Office of Audit Comment: The fact that the size and scope of the compliance issue has not been established stems from the fact that the IRS has not taken adequate steps to measure this risk. While there are legitimate reasons why discrepancies exist, *****2*****
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The IRS stated that past examinations of carryforward discrepancies yielded high no-change rates. However, for the specific examinations selected from our exception populations identified in prior reviews, the IRS did not review the carryforward credit discrepancy to ensure that the claim was valid before closing the return as a no change. Further, as noted in our report, for the 3,821 tax accounts that had an examination indicator, IRS management was unable to provide information to support that the carryforward discrepancy was addressed and resulted in no change in the examination.



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Recommendation 4: Ensure that examination case management systems capture information related to carryforward credit and deduction claim discrepancies addressed during examinations to allow for tracking and measurement of compliance risk.

Management’s Response: The IRS agreed with and has implemented this recommendation. The Small Business/Self-Employed Division has unique issue and categorization codes within its Report Generation System to record each issue addressed during examination. These unique codes include General Business Credit carryforwards. The Large Business and International Division also has specific codes in the Issue Management System to designate issues addressed during an examination. These codes include General Business Credit (Uniform Issue List Code 38-00.00 and 39-00.00), which includes the carryforward amount.

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We previously reported that individuals and businesses *****2*****
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*****2*****. For example:

- In September 2013, we reported that our review of a statistically valid sample of TY 2011 individual tax returns with General Business Credits *****2*****
*****2***** 36 of the 46 tax returns with carryforward credit amounts. We recommended that the IRS *****2*****
*****2*****. The IRS agreed with this recommendation.¹⁹
- In February 2015, we reported that our review of a statistically valid sample²⁰ of 174 Processing Year 2013 e-filed tax returns found that 131 (75 percent) *****2*****
*****2*****. We recommended that the IRS develop a process to *****2*****
*****2*****
*****2*****, we recommended that the return be identified and sent to the Error

¹⁹ TIGTA, Ref. No. 2013-40-093, *Unsupported and Potentially Erroneous Claims for General Business Credits Are Not Always Identified When Tax Returns Are Processed* p. 12 (Sept. 2013).

²⁰ We used attribute sampling to calculate a sample size of 174 business tax returns claiming a carryforward amount based on a confidence level of 95 percent, an expected rate of occurrence of 37 percent, and a precision rate of ± 7 percent. We used a contracted statistician who assisted us in developing our sampling plan and projections.



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Resolution function *****2*****. The IRS disagreed with our recommendation.²¹

Since we first reported this concern in September 2013, the IRS has *****2***** *****2*****.

*****2***** *****2***** *****2*****

Our review of a judgmental sample²² of 100 TY 2015 tax returns with General Business Credits identified that the required statements were not included with 63 of the 100 tax returns with carryforward credit amounts. *****2***** *****2*****. Specifically, IRS instructions state that for each credit, the taxpayer needs to attach a statement with the following information:

- Show the tax year the credit originated, the amount of the credit as reported on the original return, and the amount allowed for that year. Also, state whether the total carryforward amount was changed from the originally reported amount and identify the type of credit(s) involved. If the revised carryforward amount relates to unused additional research credits, attach an additional statement detailing the changes to the originally reported Form 6765, Credit for Increasing Research Activities, information for all originating credit years applicable.
• For each carryback year, show the year and the amount of the credit allowed after the taxpayer applied the carryback.
• For each carryforward year, show the year and the amount of the credit carryforward allowed for that year.

It should be noted that the IRS currently requires taxpayers claiming the corporate Foreign Tax Credit to submit a separate schedule reconciling the prior year foreign tax carryforward with the current year foreign tax carryforward. Figure 5 provides an example of this reconciliation schedule.

21 TIGTA, Ref. No. 2015-40-012, Processes Do Not Ensure That Corporations Accurately Claim Carryforward General Business Credits p. 8 (Feb. 2015).

22 A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.



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Figure 5: Excerpt of Foreign Tax Carryover Reconciliation Schedule

SCHEDULE K (Form 1118) Foreign Tax Carryover Reconciliation Schedule							
(Rev. December 2018)		For calendar year 20____, or other tax year beginning _____, 20____, and ending _____, 20____.					OMB No. 1545-0123
Department of the Treasury Internal Revenue Service		▶ See separate instructions. ▶ Attach to Form 1118. ▶ Go to www.irs.gov/Form1118 for instructions and the latest information.					
Name of corporation						Employer identification number	
Use a separate Schedule K (Form 1118) for each category of income (see instructions).							
a Separate Category (enter code—see instructions)						▶	
b If code 901j is entered on line a, enter the country code for the sanctioned country (see instructions)						▶	
c If code RBT is entered on line a, enter the country code for the treaty country (see instructions)						▶	
Foreign Tax Carryover Reconciliation	(i) 10th Preceding Tax Year	(ii) 9th Preceding Tax Year	(iii) 8th Preceding Tax Year	(iv) 7th Preceding Tax Year	(v) 6th Preceding Tax Year	(vi) 5th Preceding Tax Year	(vii) Subtotal (add columns (i) through (vi))
1 Foreign tax carryover from the prior tax year (enter amounts from the appropriate columns of line 8 of the prior year Schedule K (see instructions))							

Source: TY 2018 Form 1118, Foreign Tax Credit – Corporations, Schedule K, Foreign Tax Carryover Reconciliation Schedule.

When we shared our results with the IRS, management agreed that the information from the statement could be helpful to identify potentially erroneous carryforward claims. However, management noted that they believe it would be more effective to require the information directly on the tax form rather than on an attached statement. As such, management explained that they would pursue changes to the Form 3800 to include information similar to the information required on the carryforward statement. However, IRS management noted that moving forward with revising the tax form would be contingent on the results of their analysis of Research Credit carryforward cases with discrepancies to evaluate the level of noncompliance associated with carryforward claims.

Recommendations

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should:

Recommendation 5: Develop a strategy to evaluate possible revisions to tax forms to capture carryforward claim information similar to what is currently required for the corporate Foreign Tax Credit. While the strategy is being developed, implement an educational campaign

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*****2*****

Management's Response: The IRS partially agreed with this recommendation. IRS management agreed to develop a strategy to evaluate possible revisions to the Form 3800. However, IRS management disagreed that an educational campaign is necessary.

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Recommendation 6: Use the carryforward information obtained from implementing Recommendation 5 to identify potentially erroneous carryforward claims.

Management's Response: The IRS disagreed with this recommendation. IRS management stated that this recommendation assumes that the results of the evaluation in Recommendation 5 will lead to changes in the tax form. To properly assess this recommendation, the IRS must perform an adequate evaluation of any potential tax form changes, which should include evidence that such information would be beneficial to identifying noncompliance. This evaluation has not been completed.

Office of Audit Comment: While the timing of the implementation of this recommendation depends on the IRS's evaluation, we believe it is premature for the IRS to disagree with the recommendation.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the effectiveness of IRS controls to detect and prevent questionable carryforward claims on individual and business income tax returns. To accomplish this objective, we:

- I. Determined if processes were in place to verify the accuracy and validity of carryforward credits/deductions claimed by taxpayers at the time tax returns are processed.
 - A. Determined what corrective actions were taken by the IRS based on our prior carryforward reports and reviewed any information used to justify not taking certain corrective actions.
 - B. Evaluated returns with General Business Credit *****2***** carryforward claims to determine validity of the claims and met with IRS management to determine what processes exist to review General Business Credit carryforward claims.
 - C. Evaluated returns claiming other credits and deductions with carryforward claims that appeared to be *****2***** and met with IRS management to determine if there is a valid reason for *****2*****.
- II. Determined what information the IRS needed to ensure that carryforward amounts are accurate on tax returns containing limited carryforward information.
 - A. Met with IRS management and determined what processes exist for reviewing these type of taxpayer carryforward claims.
 - B. Reviewed tax forms in which carryforward credits/deductions could be claimed and determined how they could be revised to provide the IRS the information needed to ensure accurate carryforward amounts in the future.
- III. Determined if required carryforward statements were properly attached to General Business Credit carryforward claims.
 - A. Reviewed a judgmental sample¹ of 100 returns claiming a General Business Credit carryforward claim to determine if the proper carryforward statement was attached to the applicable tax returns. We selected a judgmental sample because we determined the sample would be adequate to indicate continued noncompliance and did not intend to project results to the population.

¹ A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.



Billions of Dollars of Potentially Erroneous Carryforward Claims Are Still Not Being Addressed

- B. Met with IRS management and determined *****2*****
*****2*****.
- C. Discussed with the IRS the fact that carryforward statements were not being consistently provided.

Data validation methodology

During this review, we relied on data stored at TIGTA’s Data Center Warehouse² from the IRS’s Individual and Business Master File for TYs 2014 through 2017. We extracted various credit and deduction audit logs and performed analysis of the data. To assess the reliability of computer-processed data, programmers within TIGTA’s Data Center Warehouse validated the data files we extracted while we ensured that each data extract contained the specific data elements we requested and that the data elements were accurate. In addition, we performed extensive validation, when available, to the Integrated Data Retrieval System.³ For example, we reviewed random samples of each file and verified that the data in the files were the same as the data captured in the IRS’s Integrated Data Retrieval System and/or the Employee User Portal application. Based on our testing, we determined the data used in our review were reliable.

Internal controls methodology

Internal controls relate to management’s plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: 1) processes and procedures used to evaluate potential questionable carryforward claims by individual and business taxpayers; 2) processes and procedures to determine if information existed on the applicable tax forms for the IRS to be able to identify questionable carryforward credits and deduction claims; and 3) processes and procedures to ensure that *****2*****
*****2*****
*****2*****. We evaluated these controls by reviewing policies and procedures, interviewing employees and management, and analyzing data.

² A collection of IRS databases containing various types of taxpayer account information that is maintained by the TIGTA for the purpose of analyzing data for ongoing audits.

³ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer’s account records.



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Appendix II

Major Contributors to This Report

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)
Diana Tengesdal, Director
Larry Madsen, Audit Manager
Ngan Tang, Acting Audit Manager
Heidi Turbyfill, Lead Auditor
Jaclynne Durrant, Auditor
Laura Haws, Information Technology Specialist (Data Analytics)



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Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Commissioner, Large Business and International Division
Commissioner, Small Business/Self-Employed Division
Commissioner, Wage and Investment Division
Director, Accounts Management, Wage and Investment Division
Director, E-File Services, Wage and Investment Division
Director, Exam Case Selection, Small Business/Self-Employed Division
Director, Exam Planning Performance and Analysis, Small Business/Self-Employed Division
Director, Examination, Small Business/Self-Employed Division
Director, Headquarters Exam, Small Business/Self-Employed Division
Director, Refundable Credits Policy and Program Management, Wage and Investment Division
Director, Submission Processing, Wage and Investment Division
Director, Office of Audit Coordination



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Appendix IV

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$5.1 billion from 18,474 taxpayers (see page 5).

Methodology Used to Measure the Reported Benefit:

Our review of TY¹ 2015 e-filed returns found that taxpayers continue to claim carryforward amounts *****2*****. We identified a total of 19,193 individual and business tax returns claiming a carryforward credit or deduction with discrepancies totaling about \$5.1 billion that was used to offset tax. Deductions are allowable against certain income types and only generate a tax effect based on the taxpayer's marginal tax rate. We applied the marginal tax rate for individuals and businesses to arrive at the tax effect for the various deductions.

To be conservative in our outcome measure, we included only individual tax returns with a potential tax effect of \$500 or more and business tax returns with a potential tax effect of greater than \$10,000. There were 715 business tax returns in which the potential tax effect was greater than \$10,000 with discrepancies totaling \$4,892,351,169. Also, 17,759 individual tax returns in which the potential tax effect was \$500 or more had discrepancies totaling \$202,869,962. There was a total of 18,474 individual and business tax returns with a discrepancy in which there was a potential tax effect totaling \$5,095,221,131.

According to IRS management, there are potential reasons why these discrepancies might exist, such as the taxpayer correcting a previous error pertaining to the carryforward or the taxpayer acquiring another business that has available carryforward credits. It is also possible that the carryforward amount would be used in later tax years and not just in TY 2015. We agree that there are reasons the discrepancy could be valid and the carryforward amount may be used in later years. However, the discrepancy is an indication that the claim is potentially erroneous. Without an examination of the claim, it would not be possible to determine whether the claim is accurate and the proper amount that should be attributed to TY 2015.

¹ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



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Appendix V

Form 3800, General Business Credit

Form 3800 Department of the Treasury Internal Revenue Service (99)	General Business Credit ► Information about Form 3800 and its separate instructions is at www.irs.gov/form3800 . ► You must attach all pages of Form 3800, pages 1, 2, and 3, to your tax return.	OMB No. 1545-0895 2015 Attachment Sequence No. 22		
Name(s) shown on return		Identifying number		
Part I Current Year Credit for Credits Not Allowed Against Tentative Minimum Tax (TMT) (See instructions and complete Part(s) III before Parts I and II)				
1	General business credit from line 2 of all Parts III with box A checked	1		
2	Passive activity credits from line 2 of all Parts III with box B checked	2		
3	Enter the applicable passive activity credits allowed for 2015 (see instructions)	3		
4	Carryforward of general business credit to 2015. Enter the amount from line 2 of Part III with box C checked. See instructions for statement to attach	4		
5	Carryback of general business credit from 2016. Enter the amount from line 2 of Part III with box D checked (see instructions)	5		
6	Add lines 1, 3, 4, and 5	6		
Part II Allowable Credit				
7	Regular tax before credits: <ul style="list-style-type: none"> • Individuals. Enter the sum of the amounts from Form 1040, lines 44 and 46, or the sum of the amounts from Form 1040NR, lines 42 and 44 • Corporations. Enter the amount from Form 1120, Schedule J, Part I, line 2; or the applicable line of your return • Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b; or the amount from the applicable line of your return 	7		
8	Alternative minimum tax: <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 6251, line 35 • Corporations. Enter the amount from Form 4626, line 14 • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 56 	8		
9	Add lines 7 and 8	9		
10a	Foreign tax credit	10a		
b	Certain allowable credits (see instructions)	10b		
c	Add lines 10a and 10b	10c		
11	Net income tax. Subtract line 10c from line 9. If zero, skip lines 12 through 15 and enter -0- on line 16	11		
12	Net regular tax. Subtract line 10c from line 7. If zero or less, enter -0-	12		
13	Enter 25% (.25) of the excess, if any, of line 12 over \$25,000 (see instructions)	13		
14	Tentative minimum tax: <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 6251, line 33 • Corporations. Enter the amount from Form 4626, line 12 • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 54 	14		
15	Enter the greater of line 13 or line 14	15		
16	Subtract line 15 from line 11. If zero or less, enter -0-	16		
17	Enter the smaller of line 6 or line 16 C corporations: See the line 17 instructions if there has been an ownership change, acquisition, or reorganization.	17		
For Paperwork Reduction Act Notice, see separate instructions.		Cat. No. 12392F	Form 3800 (2015)	



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Form 3800 (2015)		Page 2
Part II Allowable Credit (Continued)		
Note. If you are not required to report any amounts on lines 22 or 24 below, skip lines 18 through 25 and enter -0- on line 26.		
18	Multiply line 14 by 75% (.75) (see instructions)	18
19	Enter the greater of line 13 or line 18	19
20	Subtract line 19 from line 11. If zero or less, enter -0-	20
21	Subtract line 17 from line 20. If zero or less, enter -0-	21
22	Combine the amounts from line 3 of all Parts III with box A, C, or D checked	22
23	Passive activity credit from line 3 of all Parts III with box B checked 23	
24	Enter the applicable passive activity credit allowed for 2015 (see instructions)	24
25	Add lines 22 and 24	25
26	Empowerment zone and renewal community employment credit allowed. Enter the smaller of line 21 or line 25	26
27	Subtract line 13 from line 11. If zero or less, enter -0-	27
28	Add lines 17 and 26	28
29	Subtract line 28 from line 27. If zero or less, enter -0-	29
30	Enter the general business credit from line 5 of all Parts III with box A checked	30
31	Reserved	31
32	Passive activity credits from line 5 of all Parts III with box B checked 32	
33	Enter the applicable passive activity credits allowed for 2015 (see instructions)	33
34	Carryforward of business credit to 2015. Enter the amount from line 5 of Part III with box C checked and line 6 of Part III with box G checked. See instructions for statement to attach	34
35	Carryback of business credit from 2016. Enter the amount from line 5 of Part III with box D checked (see instructions)	35
36	Add lines 30, 33, 34, and 35	36
37	Enter the smaller of line 29 or line 36	37
38	Credit allowed for the current year. Add lines 28 and 37. Report the amount from line 38 (if smaller than the sum of Part I, line 6, and Part II, lines 25 and 36, see instructions) as indicated below or on the applicable line of your return: <ul style="list-style-type: none"> • Individuals. Form 1040, line 54, or Form 1040NR, line 51 • Corporations. Form 1120, Schedule J, Part I, line 5c • Estates and trusts. Form 1041, Schedule G, line 2b 	38



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Form 3800 (2015)		Page 3
Name(s) shown on return		Identifying number
Part III General Business Credits or Eligible Small Business Credits (see instructions)		
Complete a separate Part III for each box checked below. (see instructions)		
A <input type="checkbox"/> General Business Credit From a Non-Passive Activity	E <input type="checkbox"/> Reserved	
B <input type="checkbox"/> General Business Credit From a Passive Activity	F <input type="checkbox"/> Reserved	
C <input type="checkbox"/> General Business Credit Carryforwards	G <input type="checkbox"/> Eligible Small Business Credit Carryforwards	
D <input type="checkbox"/> General Business Credit Carrybacks	H <input type="checkbox"/> Reserved	
I If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III <input type="checkbox"/>		
(a) Description of credit	(b)	(c)
Note. On any line where the credit is from more than one source, a separate Part III is needed for each pass-through entity.	If claiming the credit from a pass-through entity, enter the EIN	Enter the appropriate amount
1a Investment (Form 3468, Part II only) (attach Form 3468)	1a	
b Reserved	1b	
c Increasing research activities (Form 6765)	1c	
d Low-income housing (Form 8586, Part I only)	1d	
e Disabled access (Form 8826) (see instructions for limitation)	1e	
f Renewable electricity, refined coal, and Indian coal production (Form 8835)	1f	
g Indian employment (Form 8845)	1g	
h Orphan drug (Form 8820)	1h	
i New markets (Form 8874)	1i	
j Small employer pension plan startup costs (Form 8881) (see instructions for limitation)	1j	
k Employer-provided child care facilities and services (Form 8882) (see instructions for limitation)	1k	
l Biodiesel and renewable diesel fuels (attach Form 8864)	1l	
m Low sulfur diesel fuel production (Form 8896)	1m	
n Distilled spirits (Form 8906)	1n	
o Nonconventional source fuel	1o	
p Energy efficient home (Form 8908)	1p	
q Energy efficient appliance	1q	
r Alternative motor vehicle (Form 8910)	1r	
s Alternative fuel vehicle refueling property (Form 8911)	1s	
t Reserved	1t	
u Mine rescue team training (Form 8923)	1u	
v Agricultural chemicals security (carryforward only)	1v	
w Employer differential wage payments (Form 8932)	1w	
x Carbon dioxide sequestration (Form 8933)	1x	
y Qualified plug-in electric drive motor vehicle (Form 8936)	1y	
z Qualified plug-in electric vehicle (carryforward only)	1z	
aa New hire retention (carryforward only)	1aa	
bb General credits from an electing large partnership (Schedule K-1 (Form 1065-B))	1bb	
zz Other	1zz	
2 Add lines 1a through 1zz and enter here and on the applicable line of Part I	2	
3 Enter the amount from Form 8844 here and on the applicable line of Part II .	3	
4a Investment (Form 3468, Part III) (attach Form 3468)	4a	
b Work opportunity (Form 5884)	4b	
c Biofuel producer (Form 6478)	4c	
d Low-income housing (Form 8586, Part II)	4d	
e Renewable electricity, refined coal, and Indian coal production (Form 8835)	4e	
f Employer social security and Medicare taxes paid on certain employee tips (Form 8846)	4f	
g Qualified railroad track maintenance (Form 8900)	4g	
h Small employer health insurance premiums (Form 8941)	4h	
i Reserved	4i	
j Reserved	4j	
z Other	4z	
5 Add lines 4a through 4z and enter here and on the applicable line of Part II .	5	
6 Add lines 2, 3, and 5 and enter here and on the applicable line of Part II . .	6	



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Appendix VI

Form Number and Description of Credits/Deductions

1. Form 3800, *General Business Credit*, consists of 37 credits and contains both current and carryforward credits available to offset against a taxpayer's current tax. Some of these credits are listed below:
 - a. Form 3468, *Investment Credit* – Credit consists of the total of the following credits: rehabilitation credit, energy credit, qualifying advanced coal project credit, qualifying gasification project credit, and qualifying advanced energy project credit.
 - b. Form 5884, *Work Opportunity Credit* – Credit applies to businesses that hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs.
 - c. Form 6765, *Credit for Increasing Research Activities* – Credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities, including energy research.
 - d. Form 8586, *Low-Income Housing Credit* – Credit generally applies to each new qualified low-income building placed in service after 1986 and is used by owners of qualified residential rental buildings in low-income housing projects.
 - e. Form 8820, *Orphan Drug Credit* – Credit applies to qualified clinical testing expenses paid or incurred during the tax year.
 - f. Form 8826, *Disabled Access Credit* – Credit applies to amounts paid or incurred by the eligible small businesses to comply with applicable requirements under the Americans With Disabilities Act of 1990 (Public Law 101-336) as in effect on November 5, 1990.
2. Form 8844, *Empowerment Zone Employment Credit*, is used by employers for wages paid to qualified employees residing in an empowerment zone for which the credit is available. Form 8827, *Credit for Prior Year Minimum Tax – Corporations*, and Form 8801, *Credit for Prior Year Minimum Tax – Individuals, Estates, and Trusts*, are used to figure the minimum tax credit, if any, for Alternative Minimum Tax incurred in prior tax years and to figure any minimum tax credit carryforward.
3. Form 1118, *Foreign Tax Credit – Corporations*, and Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)*, are used to compute a corporation's or individual's foreign tax credit for certain taxes paid or accrued to foreign countries or U.S. possessions.



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4. Form 8912, *Credit to Holders of Tax Credit Bonds*, is used to claim the following bonds: clean renewable energy bond, new clean renewable energy bond, qualified energy conservation bond, qualified zone academy bond, qualified school construction bond, and build America bond.
5. Form 4952, *Investment Interest Expense Deduction*, is used to figure the amount of investment interest expense that can be deduct for the current year and the amount that can be carried forward to future years.
6. Form 8396, *Mortgage Interest Credit*, is used to figure the mortgage interest credit and any credit carryforward.
7. Form 8859, *Carryforward of the District of Columbia First-Time Homebuyer Credit*, is used to claim a carryforward of the District of Columbia first-time homebuyer credit.
8. Form 1040, *U.S. Individual Income Tax Return*, Schedule D, *Capital Gains and Losses*, is used to figure overall gain or loss from transactions reported from several forms and other entities and carryover losses.
9. Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*, is used to figure the amount of any corporate interest expense deduction disallowed by section 163(j).
10. Forms 8328, *Carryforward Election of Unused Private Activity Bond Volume Cap*, and Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*, are used by the issuers of tax-exempt private activity bonds to provide the IRS with the information required by section 149 and monitor the requirements of sections 141 through 150.
11. Form 1120, *U.S. Corporation Income Tax Return*, Form 1040, and Form 1041, *U.S. Income Tax Return for Estates and Trusts*, are used by corporations to claim the net operating loss deduction.
12. Form 8834, *Qualified Electric Vehicle Credit*, is used to claim any qualified electric vehicle passive activity credit from prior years allowed on Form 8582-CR, *Passive Activity Credit Limitations*, or Form 8810, *Corporate Passive Activity Loss and Credit Limitations*, for the current year carryforward. The qualified electric vehicle credit is available to businesses and individuals.
13. Form 8839, *Qualified Adoption Expenses*, is used to figure the adoption credit and if any employer-provided adoption benefits can be excluded from income. The unused amount of carryforward credit available from previous years is reported on a supplemental worksheet in the Form 8839 instructions, which is not transcribed by the IRS.
14. Form 1040, Schedule A, *Itemized Deductions*, is used for charitable contributions or contributions of ordinary income property. The unused amount of carryforward deduction available from previous years is not reported on the form and cannot be



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determined from the return. Form 1040, Schedule A, is used by individuals to claim the amortizable bond premium deduction that is reported on the return but cannot be captured because it is combined with several other items on the same line of Form 1040, Schedule A, Line 28 “Other Miscellaneous Deductions.”¹

¹ For TY 2018, this form changed, and the line is now titled “Other Itemized Deductions” and is on line 16.



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Appendix VII

Summary of Carryback and Carryforward Periods

#	Form(s)	Taxpayers	Carryback and Carryforward Information
1	Form 3800, <i>General Business Credit</i>	Business, ¹ Individual	Carryback one year and carryforward 20 years
2	Forms 8827, 8801, <i>Prior Year Minimum Tax Credit</i>	Business, Individual	Carryforward to future years
3	Forms 1118, 1116, <i>Foreign Tax Credit</i>	Business, Individual	Carryback one year and carryforward 20 years
4	Form 8912, <i>Holdings of Tax Credit Bonds Credit</i>	Business, Individual	Carryforward to future years
5	Form 4952, <i>Investment Interest Expense Deduction</i>	Individual	Carryforward to future years
6	Form 8396, <i>Mortgage Interest Credit</i>	Individual	Carryforward three years
7	Form 8859, <i>District of Columbia Homebuyer Credit</i>	Individual	Carryforward unlimited (until used)
8	Form 1040, Schedule D, <i>Capital Loss Deduction</i>	Individual	Carryforward to future years
9	Form 8926, <i>Disqualified Interest Expense Deduction</i>	Business	Carryforward to future years
10	Forms 8328, 8038, <i>Bond Volume Cap Deduction</i>	Business	Carryforward to future years
11	Forms 1120, 1040, 1041, <i>Net Operating Loss Deduction</i>	Business, Individual	Carryback two years and carryforward 20 years
12	Form 8834, <i>Qualified Electric Vehicle Credit</i>	Business, Individual	Carryforward to future years
13	Form 8839, <i>Adoption Credit</i>	Individual	Carryforward five years
14	Form 1040, Schedule A, <i>Charitable Contributions Deduction</i>	Individual	Carryforward five years
15	Form 1040, Schedule A, <i>Amortizable Bond Premium Deduction</i>	Individual	Carryforward one year

Source: TIGTA's analysis of the IRS's internal guidelines and information presented on IRS.gov.

¹ Business tax returns include corporate and estate and trust returns.



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Appendix VIII

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

June 14, 2019

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy /s/ Mary Beth Murphy
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Billions of Dollars of Potentially Erroneous
Carryforward Claims Are Still Not Being Addressed (Audit
#201840023)

Thank you for the opportunity to review and comment on the above subject draft audit report. The tax code contains multiple deductions and credits that eligible taxpayers can use to reduce their tax liability. However, there are limits on certain tax credits and deductions which prevent taxpayers from using the entire amount in a single year. In these instances, provisions in the tax code allow taxpayers to carry back and/or carry forward the unused portion of the credit or deduction and apply some or all of it to a prior and/or subsequent year. Many of these provisions were also further modified by the passage of the Tax Cut and Jobs Act.

Your report focused on carryforward discrepancies, specifically, those instances where a taxpayer *****2***** . Carryforward discrepancies, in and of themselves, are not compliance issues. As you agreed in your report, there are legitimate reasons that discrepancies exist. These include business taxpayers acquiring another company with credit carryforwards or correcting a mistake on a prior year's return.

You conducted two prior audits which focused on carryforwards of the General Business Credit (GBC). In response to those reports, we took several corrective actions. These included establishing a workstream for returns with a GBC claim which *****2***** . We also conducted audits on a number of discrepancy cases that you identified. Those cases resulted in very few audit adjustments.

As always, we take your concerns and recommendations seriously. As part of an ongoing Large Business and International (LB&I) project on research credits, we've



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made additional improvements to our processes for identifying high-risk GBC carryforward claims. We will also start a compliance initiative project to look specifically at GBC carryforward discrepancy cases in our Small Business/Self-Employed (SB/SE) division. The results of these activities will guide our future decisions and actions on other carryforward discrepancy cases. Lastly, we plan to review our tax forms and evaluate whether revisions should be made to capture carryforward claim information.

We do not agree with your outcome measure as it is overstated. While some taxpayers may claim erroneous carryforward amounts, it is unrealistic to conclude that the tax effect is equal to the gross carryforward amount. Carryforwards are only allowable in accordance with certain tax code provisions. Thus, taxpayers may never be able to utilize the full amount of the carryforward. Finally, there are legitimate reasons that discrepancies can exist which means the carryforward amount claimed may be correct even when it doesn't reconcile to a prior year's return. We reviewed a sample of discrepancy cases you identified and did not find any invalid claims.

Attached is a detailed response to address your recommendations. If you have any questions, please contact me or Brenda Dial, Director, Examination Operations, Small Business/Self-Employed (SB/SE) Division.

Attachment



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Attachment

Recommendation 1:

The Commissioner, Large Business and International Division, should ensure that criteria is added to the Research Credit selection risk tool to identify high-risk carryforward Research Credit discrepancy claims on returns selected for examination and determine if the carryforward claims taken by the taxpayers are accurate. Based on the results of examining these returns, determine if examination criteria should be expanded to include other carryforward claims with discrepancies.

Planned Corrective Action:

LB&I agrees with this recommendation and has already added information to the risk tool on the General Business Credit carryover which will help identify *****2***** of General Business Credit carryforwards. The risk tool will help examiners assess the scope and depth of research credit examinations on business cases selected for examination. If the risk tool indicates a high level of risk, examiners will verify research credit amounts (current, carryforward and carryback) based on available resources. LB&I will review the results of the examinations that used the risk tool. If significant risk is identified, LB&I will determine the appropriate next steps on research credit cases and whether similar approaches should be taken on any of the other carryforward issues.

Implementation Date:

October 15, 2021

Responsible Official:

Director, Enterprise Activities Practice Area, Large Business and International (LB&I)

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 2:

The Commissioner, Small Business/Self-Employed Division, should identify and examine returns with discrepancies of General Business Credit carryforward claims. Based on the results of examining these returns, determine if examination criteria should be expanded to include all business and individual carryforward claims containing discrepancies.

Planned Corrective Action:

We agree with this recommendation. We will use data analytics to determine the size and scope of the non-compliance of the General Business Credit carryforward for SB/SE taxpayers. We will initiate examinations on a statistically valid sample of returns displaying a General Business Credit carryforward discrepancy between tax years. We



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will evaluate the results of our examinations to determine if the presence of a discrepancy is a good indicator that material noncompliance exists and whether examinations should be expanded to include other business and individual carryforward claims containing material discrepancies.

Implementation Date:

December 15, 2021

Responsible Official:

Director, Exam Case Selection, Small Business/Self-Employed Division (SB/SE)

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 3:

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should prepare and submit an information technology request **2**
*****2***** apply selection criteria to determine if the carryforward claim is valid.

Planned Corrective Action:

We disagree with this recommendation based on the assertion that carryforward discrepancies are a compliance issue. Carryforward discrepancies, in and of themselves, are not compliance issues. There are legitimate reasons that discrepancies exist. The size and scope of the compliance issue, if any, has not been established. Thus, the potential benefits, if any, of such a system are unknown. Past examinations of GBC carryforward discrepancies yielded high no change rates. It could be several years before we have adequate examination results from the review of the cases in recommendations 1 and 2, let alone other carryforward issues, to determine if a compliance issue exists.

Any request for an Information Technology (IT) investment is unsupported without a proper cost benefit analysis. This analysis cannot be accomplished until we determine if there is a compliance issue. We do know that implementation of such a system would require a significant amount of increased transcription of paper returns as well as a significant cost to our IT programming resources.

Finally, we must balance the use of our limited enforcement resources. Even if the results of future credit carryforward examinations identify non-compliance, we must consider the risk of placing additional carryforward returns into the audit stream thereby potentially bypassing other returns with higher audit potential.



*Billions of Dollars of Potentially Erroneous
Carryforward Claims Are Still Not Being Addressed*

Implementation Date: N/A

Responsible Official: N/A

Corrective Action Monitoring Plan: N/A

Recommendation 4:

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should ensure examination case management systems capture information relating to carryforward credit and deduction claim discrepancies addressed during examinations to allow for tracking and measurement of compliance risk.

Planned Corrective Action:

We agree and have implemented this recommendation. SB/SE has unique issue and categorization codes within its Report Generation System (RGS) to record each issue addressed during examination. These unique codes include general business credit carryforwards. LB&I has specific codes in the Issue Management System (IMS) to designate issues addressed during an examination. These codes include General Business Credit (UIL 38-00.00 and 39-00.00) which would include the carryforward amount.

Implementation Date:

Implemented

Responsible Officials:

Director, Exam Case Selection, Small Business/Self-Employed Division (SB/SE)
Director, Enterprise Activities Practice Area, Large Business and International (LB&I)

Corrective Action Monitoring Plan: N/A

Recommendations 5:

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should develop a strategy to evaluate possible revisions to tax forms to capture carryforward claim information similar to what is currently required for the corporate Foreign Tax Credit. While the strategy is being developed, implement an educational campaign *****2*****
*****2*****

Planned Corrective Action:

We agree in part with this recommendation. We agree to develop a strategy to evaluate possible revisions to the Form 3800 General Business Credit. We do not agree an



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educational campaign is necessary. *****2*****
*****2*****.

Implementation Date:

April 15, 2020

Responsible Official:

Director, Exam Quality & Technical Support, Small Business/Self-Employed Division (SB/SE)
Director, Enterprise Activities Practice Area, Large Business and International (LB&I)

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 6:

The Commissioners, Large Business and International and Small Business/Self-Employed Divisions, should use the carryforward information obtained from implementing Recommendation 5 to identify potentially erroneous carryforward claims.

Planned Corrective Action:

We disagree with this recommendation. The recommendation assumes that the results of evaluation in recommendation 5 will lead to changes in the tax form. To properly assess this recommendation, we must perform an adequate evaluation of any potential tax form changes which should include evidence that such information would be beneficial to identifying non-compliance. The evaluation has not been completed. Thus, we cannot agree to this recommendation at this time.

Implementation Date: N/A

Responsible Official: N/A

Corrective Action Monitoring Plan: N/A