



EP Examination Process Guide - Discrepancy Adjustments

This program allows EP agents to make certain line adjustments to income tax returns with respect to issues arising from an examination of a return of a qualified retirement plan or an exempt organization with respect to tax adjustments to Forms 1040 and 1120.

What is a Discrepancy Adjustment?

A discrepancy adjustment is an adjustment to an income tax return to correct a discrepancy between facts developed during an EP Compliance Activity (such as the examination of an employer's pension plan) and line items on a related income tax return (such as a 1040 or 1120). If the income tax return as filed accurately reflects the facts developed during the compliance activity, there is no discrepancy and no adjustment. If the income tax return does not accurately reflect these facts, a discrepancy exists and the adjustment will be proposed. The taxpayer is free to present, and the EP agent is free to consider, any documentation supporting the accuracy of the income tax return as filed. The taxpayer may also present additional non-pension related adjustments to the return to be included with the discrepancy adjustment for the revenue agent's consideration.

The discrepancy adjustment program was created to reduce the number of referrals for Income Tax examinations for what may require essentially a minor recalculation of tax. This program allows an EP agent to make certain line adjustments to income tax returns with respect to issues arising from an examination of a qualified retirement plan.

Adjustments can be made to:

- Form 1040, U.S. Individual Income Tax Return, and
- Form 1120, U.S. Corporation Income Tax Return.

The discrepancy adjustment program does not entirely preclude EP discrepancy adjustments from being referred for examination. If the adjustment does not fall within the guidelines of the discrepancy adjustment program, a referral for examination should be made. The following are examples of discrepancies which require referral:

- Form 1120-S, U.S. Tax Return for an S Corporation.
- Form 1065, U.S. Return of Partnership Income.
- If the return shows a net operating loss.
- Was filed by a taxpayer that has filed for bankruptcy.
- Was filed by a taxpayer that was dissolved, merged or sold.

- Is under the jurisdiction of IRS-LMSB - International or is listed in the IRS-CEP Identity File.
- Was never filed (no delinquent Forms 1040 or 1120 return will be secured).
- Is currently under examination.
- Involves complex credit carry backs.
- Involves capitalized pension or profit sharing costs.

Example of a Discrepancy Adjustment:

The examination of the ABC Company's Pension Plan indicated Joe Taxpayer received a distribution of \$10,000. However, Joe Taxpayer's Form 1040 did not include the distribution in income. The revenue agent will propose an adjustment to Joe Taxpayer's Form 1040 to include the \$10,000 in income. Joe Taxpayer will receive a written adjustment explaining the tax law on which the adjustment is based and the tax effect of the adjustment. Joe Taxpayer can then provide additional information for the revenue agent to consider explaining why he did not include the amount in income, such as a proper and timely rollover to an IRA or a return of after-tax basis.

Some additional examples of discrepancy adjustments are:

- Plan records reflect a contribution to the plan which does not match the amount deducted on the Form 1120 return.
- Excess deductions taken on the employer's income tax return.
- Failure to report a loan that violated IRC section 72(p).
- Failure to properly calculate the maximum deduction on the part of a self-employed Individual.

Is a Discrepancy Adjustment an Examination of the Return?

No, the Office of Chief Counsel has concluded that discrepancy adjustments do not constitute an inspection of the taxpayer's books and records within the meaning of IRC section 7605(b).

An income tax examination is an inspection of a taxpayer's books and records to determine the accuracy of an income tax return filed by that taxpayer. An EP examination is an inspection of a plan's books and records to determine the accuracy of the Form 5500 filed. An examination of a business' 5500 series return does not constitute an income tax examination of the business itself, even if the year is the same and even though some books and records might be common to both the business and its qualified plan.

Rev. Proc. 2005-32, section 4.03, defines IRS procedures that are neither considered case reopenings nor examinations. Discrepancy Adjustments are covered by this section. Under section 4.03(4), contacting a taxpayer to correct mathematical errors and verifying or adjusting a discrepancy between the tax return and an information return, including inspection of a taxpayer's books of account to the extent necessary to resolve the discrepancy, are not considered examinations or case reopenings. No individual closing letters are issued on discrepancy adjustments.