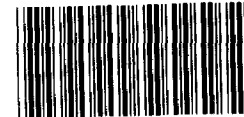


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STATEMENT OF
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GENERAL GOVERNMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON COMMERCE, CONSUMER
AND MONETARY AFFAIRS,
COMMITTEE ON GOVERNMENT OPERATIONS
HOUSE OF REPRESENTATIVES
ON
IRS' INFORMATION RETURNS
MATCHING PROGRAM



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here this morning to assist the Subcommittee in its inquiry into the status of the Internal Revenue Service's (IRS) Information Returns Program (IRP)--a major enforcement program used to identify unreported income. Our testimony today is based primarily on work performed in response to your request of January 16, 1986, and will complement our recent report to you on the need for IRS to improve the accuracy of non-wage income data.

We performed our work at four IRS service centers, the National Computer Center (NCC), and the IRS National Office. We interviewed various IRP program officials and analyzed IRS policies, procedures, and studies related to this program. We also relied heavily on statistical data provided by IRS in developing the information in this statement. Because of tight timeframes, we did not assess the effectiveness of this program.

We specifically focused our work on the following areas of particular interest to you and your subcommittee: (1) trends in information returns received and matched, and cases followed up, (2) information returns not used in the matching process, (3) efforts to follow up on underreporter and nonfiler cases, (4) enforcement of the information returns reporting requirements, and

(5) efforts to improve magnetic media and paper returns processing.

We found that:

--First, the Information Returns Program has grown since its inception in tax year 1974. The volume and type of information returns received and matched, the number of cases followed up, and the number of assessments made have increased. This increase can be contributed in large part to the importance attached to the program by Congress as well as IRS. In its fiscal year 1987 budget submission, IRS presents the Information Returns Program as one of its major enforcement initiatives.

--Second, millions of information returns still go unused in the matching process for a variety of reasons. For example, information returns for businesses are not used because IRS has not yet developed a business matching program. Some information returns for individuals are either received with incorrect data, such as inaccurate income amounts, or too late to be used. Still others are omitted from the matching process because of problems with the handling of the information returns once received. These control problems have resulted in lost computer tapes containing income information and are discussed in more detail in our report as well as later in this statement.

--Third, IRS case follow-up is limited due to budgetary constraints. As a result, IRS does not follow-up on all potential identified underreporter cases. Furthermore, IRS performs partial versus complete follow-up for a number of nonfiler cases.

--Fourth, IRS does not have a separate audit program to specifically investigate violators of reporting requirements. Instead, it enforces and monitors information reporting requirements through the existing examination and collection processes. IRS recognizes that it can do more to bolster enforcement and is currently developing a Payer Master File Program which is specifically designed to identify those payers who violate the reporting requirements. IRS also plans to have a more active penalty and backup withholding enforcement program than it has had in previous years. Over the last two fiscal years, few penalties have been levied because of IRS' belief that payers needed time to adjust to new or changed reporting requirements.

--Fifth, IRS has taken initiatives to more efficiently process information returns by promoting the use of magnetic media filing and by using electronic data transcription for paper information returns.

Mr. Chairman, I would now like to provide some background on the Information Returns Program before discussing each of your areas of interest.

BACKGROUND

The concept of matching information returns to income tax returns for the purpose of identifying unreported income was endorsed by IRS as early as the 1960's. But for the most part, IRS did not perform extensive returns matching until an automated system was implemented in 1974. At that time, IRS established the Information Returns Program (IRP).

IRP is primarily designed to detect unreported income. During the IRP process, information returns are computer matched with individual tax returns to identify potential underreporters and nonfilers. If the income or deductions reported on the information returns do not agree with that reported on the tax return and if there is potential for additional tax, a potential underreporter case exists. If the information returns cannot be associated with a tax return, a potential nonfiler case exists. Once these underreporter and nonfiler cases are identified through the matching process, IRS attempts to select the most productive cases for follow-up, usually in the form of a detailed screening of the case, which may or may not result in a notice to the taxpayer. The notice requests the taxpayer to explain the discrepancy, file a return or pay the additional tax owed. Attachment I describes in detail how the IRP process works.

The majority of documents used in the matching process are information returns for interest, dividends, and wages. Recent legislation, however, such as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Tax Reform Act of 1984 (TRA), expanded the IRP process by requiring various third parties, commonly referred to as payers, to supply IRS with new types of information returns. Some of these information returns report income, such as broker transactions and state income tax refunds. Others report deductions from income, such as foreclosure proceedings and mortgage interest. Attachment II lists the various types of information returns that IRS currently uses and plans to use in the matching process. Attachment III provides an overview of the major legislation that affected this program.

I would now like to focus on the particular aspects of IRP that you asked us to address. The first area deals with trends regarding information returns received and matched, and cases followed up as a result of the match.

INCREASE IN RETURNS RECEIVED AND
MATCHED, AND CASES FOLLOWED UP

IRS' current goal is to use all information returns received and follow up on all potentially productive underreporter and nonfiler cases. IRS has pursued this goal in an environment of program growth.

Between tax years 1979 and 1983 (the most recent 5 year period for which complete data is available) the statistical trends for information returns received, processed, and used for matching were as follows:

- Information returns received increased by 23 percent, from 563.6 million to 694.7 million.

- Information returns processed, that is, those forwarded for matching after initial screening, increased by 29 percent from 491.8 million to 634.6 million.

- Information returns actually used for matching purposes, after final screening, increased by 20 percent from 450.2 million to 541.3 million.

IRS officials told us that the number of information returns received will continue to increase, especially in light of the new types of information returns required since tax year 1983. IRS currently estimates that the number of information returns received for tax year 1988 will exceed one billion. Although no statistical estimates exist on the number of returns that will be processed and matched, IRS officials believe that these numbers will also increase.

IRS efforts to match information returns have improved since tax year 1974 when 35 percent of the returns received were matched. For tax year 1983, 78 percent of the returns received were matched. These matches resulted in underreporter cases and nonfiler cases.

We reviewed IRS statistics for underreporter and nonfiler cases for tax years 1979 to 1982. The number of underreporters identified by information returns matching fluctuated during that time, ranging from 8.1 million to 9.7 million. The percentage of cases followed-up also fluctuated. For example, for tax year 1979, 34 percent of the underreporter cases were followed up, as compared to 88 percent for tax year 1982. As previously stated, this follow-up consisted of manual screening of cases, which might or might not have resulted in sending notices to taxpayers. For those cases followed-up, IRS sent about 1.2 million underreporter notices for tax year 1979 and 4.1 million for tax year 1982.

Like the underreporter notices, the number of nonfiler notices also increased between tax years 1979 and 1982. IRS generated 2.4 million nonfiler notices for tax year 1979 and 2.8 million for tax year 1982. If a potential nonfiler case meets a minimum criteria for tax change IRS usually sends at least one notice.

As could be expected, given the growth in information returns received and case follow-up, assessments resulting from these underreporter and nonfiler cases also increased between tax years 1979 and 1982. For tax year 1979 cases, total net assessments were \$695 million, while for tax year 1982, assessments grew to \$2.4 billion. IRS projections for future assessments indicate continued growth. For example, IRS projects an increase in assessments to almost \$3 billion for tax year 1984 cases.

We were unable to specifically determine the amount of assessments generated by the information returns recently required by legislation since those cases are still being followed up. Attachments IV through VII provide detailed information on returns received, processed, and matched; underreporter and nonfiler cases generated and followed up; and assessments.

As we have shown, IRP has grown since 1974. IRS has received, processed, and matched large volumes of information returns annually. Nevertheless, millions of returns still go unmatched.

IRS DOES NOT MATCH ALL
INFORMATION RETURNS RECEIVED

We identified the following five major reasons why IRS does not match all information returns received: (1) no program to match information returns for businesses, (2) receipt of information returns that do not include all the data necessary for matching, (3) returns that have been incorrectly prepared or received too late for the matching process, (4) problems with management and control of magnetic tapes, which in the past has resulted in lost or erased information returns, and (5) cost of manually transcribing some paper returns. For tax year 1983, most of these reasons contributed to IRS not matching about 153 million or 22 percent of the 694.7 million information returns received. I will now discuss each of these reasons in more detail.

1. Information Returns For Businesses Are Not Used Because IRS Does Not Have A Business Match Program--IRS does not have a document matching program for business taxpayers. In December 1981, IRS concluded that there were various problems associated with establishing a program for matching business information returns with tax returns. IRS found that (1) about 60 percent of business taxpayers file returns on a fiscal year basis whereas information returns are filed by calendar year; (2) many business taxpayers file returns using the accrual method of accounting, but information returns reflect payments on a cash basis; and (3) some business

taxpayers receive information returns under a variety of names but report their income under one name. As a result, IRS does not use information returns for businesses in the matching process.

However, the most recent IRS data sources indicate that for tax year 1983 IRS received at least 12.5 million information returns on various types of business entities (corporations, partnerships, and proprietorships), reporting about \$500 billion in payments. Most of the \$500 billion was for interest and dividend income. Since businesses represent a large segment of the taxpaying population and the amount of income reported on information returns is significant, we are examining the potential for matching business information returns. Currently, we are attempting to (1) measure the extent to which businesses are not reporting income, such as interest and dividends, and (2) determine the feasibility of establishing a cost effective business matching program.

We are analyzing the 12.5 million business information returns that IRS received for tax year 1983 to identify the types of businesses and income that make-up these returns. In addition to analyzing the make-up of these information returns, we have taken a small preliminary random sample. We are matching the sampled information returns to the related income tax returns. Based upon the results achieved from our

preliminary sample, we will decide whether and, if so, how to select a statistically valid sample from the 12.5 million returns.

2. Some Information Returns Were Not Designed To Adequately Include All Data Necessary For Matching--As designed by IRS, some of the information returns do not provide the data needed for matching purposes. For example

--Form 5498 (Individual Retirement Account transactions) captured data on the amount deposited in the account by the taxpayer. However, the form did not specifically require the payer to designate the year that the deposit should be applied. Consequently, IRS could not determine from the form how much of the deposit to match to the tax return. As a result, IRS wrongly identified underreporter cases. For tax year 1985, IRS redesigned and expanded the amount of data on the Form 5498. For this reason, IRS believes it will be able to fully use Form 5498 for matching in tax year 1985.

--Form 1099A (foreclosure and abandonment information), which was first required for tax year 1985, will not be used. The form is not designed to provide all of the necessary information, such as depreciation taken, to

determine the correct loss resulting from foreclosure on property. Because of this, IRS will not be able to accurately determine true loss for tax purposes. Since IRS is still reviewing the situation for Form 1099A, there are no estimates on when it will be used for matching purposes.

3. Some Information Returns Have Been Incorrectly Prepared or Received Too Late For The Matching Process--IRS receives many information returns that contain incorrect data, such as erroneous taxpayer identification numbers and payer errors with respect to the income amount reported. IRS also receives information returns too late for processing, such as those from foreign governments and the Social Security Administration (SSA). The following examples illustrate these problems.

--Some Information Returns Do Not Contain Correct Taxpayer Identification Numbers (TINs)--A TIN is usually an individual's social security number. Without a correct TIN, IRS cannot computer match the dollars on the information return with the dollars on the tax return. In such cases, IRS attempts to identify the correct number so that the TIN on the information return can eventually be matched against the appropriate income tax return. All documents with TIN problems that cannot be readily corrected are eliminated from the current year's

match. Recent data show that IRS drops an average of 8.7 million non-wage information returns per year because the documents are received without TINs and are not readily correctable. IRS is attempting to correct this situation through such efforts as working with SSA to use social security number information to correct returns with TIN problems.

--Some Information Returns Are Unusable Due To Payer

Error--When payers supply incorrect or incomplete data on the information returns, these returns are unusable. For example, in one case a company reported unemployment compensation as rents; in another case, a company identified amounts on every W-2 as allocated tips, even though that company did not hire employees into positions that generate tip income. Frequently, IRS does not identify these problems until after the information returns enter the processing stream. Two examples demonstrate this point.

--Two hundred customers of a Texas bank received underreporter notices for failure to report all of their interest income from savings. IRS officials told us that the information returns supplied by

the bank on magnetic tape were erroneous. According to IRS staff, a piece of commercially marketed software used by the bank to prepare the magnetic tape was flawed and thus caused income to be incorrectly reported for the individuals who received the notices from IRS. One of these taxpayers was notified that she owed approximately \$800 in tax, penalties and interest on about \$4,000 in unreported income, when in fact she did not. According to IRS, the problem with this particular piece of software goes far beyond the Texas case. To date, tapes received from 50 payers reporting income for approximately one million taxpayers have been affected by this software problem. IRS has (1) consulted with the software manufacturer to correct the situation and (2) taken steps to identify erroneous cases created by this problem. Cases of erroneous reporting, such as this one, result in wasted resources for IRS in sending the notices and inconvenience for the taxpayers in responding to them.

--Despite its efforts to detect coding errors made by payers, IRS placed 700,000 miscoded interest and dividend returns on the IRP master file for

tax year 1983. While IRS has taken action to better identify coding errors, the fact that so many errors occurred reflects the poor quality of information returns sometimes received from payers. Problems with coding errors are described in more detail in our report.

Currently, IRS maintains a "bad payer list," which contains payers who provided IRS with inaccurate information returns such as the Texas example presented above. The most recent list is for tax year 1983 and contains over 400 payers of income. IRS attempts to contact these payers to notify them of the errors in order to prevent future inaccuracies.

--Some Information Returns Are Not Filed Timely Or Completely By Foreign Entities-- Each year IRS receives information returns from foreign governments which report income paid to U.S. taxpayers. Between tax years 1979 and 1983, IRS received about 794,000 foreign information returns per year. About 376,000 of these returns per year were not used in the matching process. IRS information indicates that the more common reasons for not using foreign information returns are that forms arrive late or without the data necessary for matching (such as TINs). IRS and the Treasury Department

work with foreign tax authorities to encourage timely and accurate income reporting by foreign payers of income.

--Some Information Returns Are Received Late From SSA--Al:

Forms W-2 and W-2P are first submitted to SSA by payers. SSA then records social security information for its use and forwards the income information to IRS. IRS cannot match this income information from SSA if it is received too late to be prepared for computer matching. For example, during a recent tax year IRS received about 3.9 million Forms W-2 too late from SSA to be processed and matched. IRS and SSA officials said that these information returns are received late because SSA received them late from the payers. Over recent years, IRS has extended the cutoff date for receiving SSA data in an attempt to use as much of the data as possible. Statistics show that on a yearly basis an increasing number of the information returns received from SSA are used for matching. IRS officials said that resources permitting, they will develop a plan to conduct a second match of all late SSA data, as well as other returns received late from all the various payers, such as the foreign documents discussed above.

4. Some Information Returns Are Not Processed Because Of Problems With Management Control--IRS' management and handling of information returns has resulted in some returns not being matched. A noteworthy example is cited in our report. That example involves 58 IRP computer tapes on magnetic media, which contained about 4.1 million information returns possibly amounting to over \$3 billion in interest and dividend income. Most of the information returns contained on the 58 tapes were not processed because the tapes were temporarily lost or totally erased. This occurred because IRS did not adhere to procedures during processing. As a result, IRS only used about 5,300 of the 4.1 million returns for matching purposes.

In addition to this example, IRS officials recently identified similar instances involving information returns not processed. For example, tapes containing about 320,000 Forms 5498, which report Individual Retirement Account transactions, were never forwarded for matching by one IRS service center. IRS officials told us that the returns were "overlooked" and unavailable for matching. In addition, IRS found 71,000 foreign information returns in a particular service center file 3 months after program completion--again, too late for use in the matching process. As will be discussed later in my statement, IRS has taken steps to reorganize its system of receiving and

using magnetic tapes so as to limit the movement of these tapes and tighten controls. IRS officials believe that this will help to prevent the recurrence of past experiences with erased and/or lost tapes.

5. Some Paper Information Returns Are Too Costly To Transcribe To Magnetic Tape--Small business corporations, partnerships, and trusts file income tax returns annually on Forms 1120S, 1065, and 1041, respectively. These types of organizations are not taxpayers per se; rather, they act as conduits for income earned by each shareholder, partner, or beneficiary. Each individual's income is reported by the filing entity on a paper information return called a Schedule K-1. The income reported on this information return is taxable to those individuals and should be reported on their income tax returns.

Schedules K-1 are used like information returns; the income reported is matched against the individual's income tax return to identify nonreporting. However, IRS must manually transcribe these paper returns to magnetic tape; therefore, it only selects a sample each year for the matching program because of the cost of manual transcription. As a result, over a recent 5-year period IRS did not use about 59 million Schedules K-1 for matching. IRS' Internal Audit staff estimated that for tax year 1982 as much as \$10 billion went unmatched because of the limited use of the Schedules K-1. As a result, IRS is now

exploring electronic filing of Schedules K-1 as a way to reduce the number not matched. Attachment VIII provides more detail on the use of Schedules K-1 in the IRP match.

As discussed in this section, millions of information returns are not used. Unused returns neither generate additional revenue nor identify unreported income. At this point, I would like to discuss IRS efforts to follow up on the potential underreporter and nonfiler cases identified during matching.

IRS DOES NOT FOLLOW UP ON ALL POTENTIAL
UNDERREPORTER AND NONFILER CASES

According to IRS officials, budgetary restrictions keep them from following up on all identified potential underreporter cases. The most recent data available--for tax years 1979 through 1982--shows that IRS' matching process identified close to 36 million cases where taxpayers appeared to have underreported their incomes. Those cases were all computer identified as potential underreporter situations meeting IRS' minimum dollar criteria for tax change. IRS records indicate that over 14 million (or about 41 percent) of them were not followed up due to "budgetary restrictions." Given the

lack of resources, IRS officials analyze the inventory of potential underreporter cases and attempt to select those cases they believe have the highest tax potential.

Since IRS cannot work all identified underreporter cases, case selection is extremely important. IRS selects follow-up cases by using a computer model to calculate yield/cost ratios for various categories of underreporter cases. IRS is attempting to improve the selection process by developing a management information system (MIS) to provide more current case data to complement this computer model. IRS hopes to use yield/cost ratios in conjunction with the more timely and complete data that an MIS can provide. IRS officials believe that the new system will improve its ability to select the most productive cases for follow-up. IRS expects this system to be implemented in early 1987.

Unlike identified underreporter cases, nonfiler cases which meet the minimum tolerance level usually get some type of follow-up. This follow-up often consists of at least one, and in some instances, two notices to the taxpayer. If the matter cannot be resolved after the second notice, the case may be closed, especially if IRS judges the case to be of lower tax potential than others needing further action. According to program officials, this "cut" is made to assure that IRS uses its resources to pursue the most productive nonfiler cases

beyond the second notice. The most recent 4-year period for which data is available indicates that 10.4 million nonfiler cases resulted in notices to taxpayers. IRS officials were unable to specifically identify how many of the cases had limited follow-up, even though they believe that the volume was significant.

Despite the fact that IRS does not completely follow-up on all identified underreporter and nonfiler cases, the program is still able to generate significant assessments. According to IRS statistics for tax year 1982, IRP generated \$2.4 billion in assessments at a 17 to 1 yield to cost ratio. IRS' fiscal year 1987 budget is calling for a 22 percent increase in funds for IRP.

I would now like to discuss IRS efforts to enforce and monitor the information returns reporting requirements. These efforts have a direct impact on how many information returns are filed, whether the documents filed are usable, and how many potential underreporter and nonfiler cases are generated.

IRS DOES ENFORCE THE INFORMATION
RETURNS REPORTING REQUIREMENTS THROUGH
ITS EXAMINATION AND COLLECTION ACTIVITIES

Since IRS does not have a separate audit program specifically designed to identify and then investigate violations of the information reporting requirements, it primarily enforces and

monitors information reporting compliance through the existing examination and collection processes. Complementing these enforcement efforts are backup withholding procedures and a variety of penalties for noncompliance with reporting requirements. IRS is also developing a Payer Master File Program, which is specifically designed to identify those payers who do not comply with the requirements. This program, however, is not expected to be fully operational until calendar year 1988.

Initiatives For Monitoring Compliance
With The Reporting Requirements

During the examination and collection process, IRS uses two basic procedures for detecting noncompliance with information returns reporting requirements. They include (1) "package audits"--a procedure whereby taxpayers being examined for any reason are also checked for compliance with the information returns reporting requirements and (2) "full compliance checks"--a procedure whereby taxpayers being pursued for collection of taxes are also checked for general compliance with other IRS requirements, including those for information reporting. IRS has used these procedures for a number of years, but has not maintained information to show how often the procedures identified payer noncompliance with the reporting requirements.

In addition to these procedures, IRS is currently developing a computerized Payer Master File to monitor payers who should comply with the reporting requirements. IRS will use the Payer Master File to collect and maintain data on payers who file information returns. IRS will then use this data in an attempt to identify payers who (1) stopped filing or never filed and (2) did not file timely and on magnetic media when required.

IRS' first attempt to implement the Payer Master File began in 1985 with its efforts to identify payers who filed information returns in one year but not in the next--the so called stopfilers. IRS compared tax year 1982 filings with tax year 1983 filings and generated over 49,000 Payer Master File stopfiler cases. As a result, IRS issued approximately 41,000 notices in April 1985.

Once these stopfiler notices were mailed, however, IRS began receiving feedback from payers which indicated that many of the notices may have been invalid. IRS found that problems existed with its input of paper and magnetic media information returns into the Payer Master File. IRS is in the process of trying to identify and correct the causes of these problems and has suspended the Payer Master File Program until all returns in the system are corrected and new data is input correctly. IRS is currently taking steps such as validating names and TINs to assure

that all paper and magnetic media data are correctly input into the File. IRS expects to fully implement this program in calendar year 1988.

As I previously mentioned, there are backup withholding procedures and a variety of penalties to supplement IRS' enforcement initiatives. I would now like to briefly discuss these procedures and penalties.

Backup Withholding

In tax year 1984, Congress established backup withholding procedures to better assure compliance with information returns reporting requirements and to encourage full income reporting by taxpayers on tax returns. If taxpayers violate certain requirements, payers are required to withhold income at a rate of 20 percent and to periodically forward the money to IRS. Some of the major areas where backup withholding is required include the following:

- when a payee does not provide a payer with a TIN, exemption certificate, or valid reason for not providing the number;
- when IRS notifies the payer that the payee provided an incorrect number and the payer is unable to correct it;

--when a payee fails to report or underreports dividend or interest income and does not resolve the matter with IRS.

IRS knows that backup withholding has been occurring. For example, IRS figures show that between July 1, 1985, and December 31, 1985, IRS received backup withholding payments from payers in about 29,000 instances, accounting for about \$151 million. IRS normally monitors backup withholding through its examination and collection coverage.

However, IRS officials said that they have plans to become more active in monitoring backup withholding. For example, IRS plans to identify information returns received with missing or incorrect TINs and then contact the payers to assure that backup withholding is occurring as required.

At this point I would like to briefly discuss some of the reporting penalties available to IRS.

Penalties

Beginning in tax year 1983, legislation such as the Tax Equity and Fiscal Responsibility Act (TEFRA), the Interest and Dividend Tax Compliance Act (IDTCA), and the Tax Reform Act of 1984 (TRA) increased the number and dollar amount of penalties that IRS could impose against violators of the information returns

reporting requirements. These penalties are for such violations as failure to file information returns (1) on magnetic media, (2) in processable condition, (3) with correct TINs, and (4) on time. The majority of the new and strengthened penalties were included in TEFRA, went into effect during tax year 1983, and were revised one year later through IDTCA.

IRS officials said that they decided to gradually institute penalty enforcement because of the number and extent of these recent legislative changes. These officials said that this decision was based, for the most part, on

--IRS' belief that payers needed time to adjust to the new legislative requirements and

--IRS' need to redesign existing penalty programs to reflect these changes.

IRS program officials said that as a result of this decision, penalty assessments for tax years 1983 and 1984 have been somewhat limited. For example, for tax year 1984 IRS received over 7 million returns without TINs but only contacted a limited number of payers. Furthermore, they have yet to assess any TIN penalties in these cases. In addition, IRS did not assess any penalties for failure to file on magnetic media, even though IRS identified a potential 12,704 penalty situations. These officials

did say, however, that they plan to become more active in the penalty area for tax year 1985.

I would now like to discuss IRS' current efforts to improve its processing of information returns.

IRS HAS EFFORTS UNDERWAY TO IMPROVE
INFORMATION RETURNS PROCESSING

IRS has taken various steps to improve its efficiency in processing information returns. IRS' efforts in this regard have been to (1) promote the use of magnetic media filing and (2) introduce the use of electronic data transcription for paper information returns. As a result of these efforts, IRS is receiving more documents on magnetic media than ever before and is able to transcribe and use larger volumes of paper information returns.

IRP Magnetic Media Program

IRS established the Magnetic Media Program in the early 1960's to encourage various payers to place wage and non-wage information on magnetic tapes. According to IRS officials, when more returns are processed on magnetic media, program costs are lowered. This is the case because IRS can use a totally automated

system to process magnetic media filings; on the other hand, for paper returns, IRS staff must manually open envelopes, sort documents, and transcribe the data onto magnetic tape. For tax year 1965, IRS received about 18 million information returns on magnetic media for wage and non-wage income. For tax year 1983, almost 600 million wage and non-wage information returns were received on magnetic media. This 600 million comprised about 85 percent of all information returns received.

In an effort to further encourage magnetic media filing, IRS established the Magnetic Media Promotion Program in 1978. This program identifies paper filers with the potential to file on magnetic media and then assists them in doing so. IRS staff serve as contact points to explain the technical procedures for filing on magnetic media and to monitor the quality of magnetic media received from the payers. The overall objective of the program is to increase the quantity and quality of information returns reported on magnetic media.

In a more recent effort to better utilize computer capacity and staff, IRS reorganized its entire magnetic media effort. This reorganization took place between January 1, 1985, and January 1, 1986, with all responsibility moving from the ten service centers to NCC.

A major improvement that IRS anticipates from centralizing the magnetic media function at NCC is control over their IRP tapes. In the past, the movement of tapes between NCC, the service centers, and the payers contributed to some tape control problems, as evidenced in the 58 "lost" and/or erased IRP tapes for tax year 1983. All magnetic media filings now go directly to NCC from the payers. This reduces the probability of tapes being lost or misplaced. Now, the only movement of these tapes occurs on those occasions when tapes need to be returned to payers for reasons such as coding corrections. NCC staff are currently developing a tracking system to log tapes when received, returned to payers for correction, and re-received.

The Use of Optical Character
Recognition (OCR) Equipment
For IRP

A second major IRS effort to improve its processing of information returns is the use of OCR equipment. OCR equipment has the ability to rapidly read information returns and transform what it reads to magnetic tape. The tape, in turn, is then used in the matching process at NCC.

Before OCR, IRS used computer terminals to manually transcribe a sample of non-wage paper information returns. The sample amounted to approximately 25 percent of all paper information returns received annually. IRS believes that such manual transcription is labor intensive and reduces the cost effectiveness of IRS information returns processing. By using OCR equipment for tax year 1983 returns, IRS almost tripled the number of paper information returns transcribed to magnetic tape compared to tax year 1982--from 17.8 million to 50.4 million. IRS estimates that the additional returns processed via OCR (the difference between the 17.8 and 50.4 million) could generate a net of \$125 million in additional taxes annually.

While OCR equipment has enabled IRS to process more paper returns than ever before, it has not eliminated the need for IRS to still manually transcribe some paper returns. Based on our analysis for tax year 1984, we found that at least 9 million Form 1099 type paper information returns had been transcribed manually. The primary reason for this manual transcription was that some information returns were not completed or printed in accordance with OCR equipment requirements. IRS is working to improve the situation by notifying the payers and by explaining the problems with the returns submitted. In this way, IRS hopes to better assure that all paper information returns are suited for OCR processing.

SUMMARY

In sum, IRP has grown significantly since its inception in 1974; IRS receives, processes, and matches large volumes of information returns annually. Nevertheless for tax year 1983, about 153 million of these returns went unmatched.

In addition to not using all information returns for matching, IRS has not been following up on all potential underreporter and nonfiler cases identified by the IRP matching process. IRS officials cite budgetary constraints as the primary reason for this. Because of the limited follow up due to budgetary constraints, IRS is attempting to develop a better methodology for selecting the most productive cases for follow up.

Despite the fact that IRS has not been able to follow up all potential cases, IRP has generated significant assessments. Given the importance of IRP as an enforcement tool for identifying unreported income, IRS is taking action to bolster enforcement efforts and to improve return processing.

This concludes my prepared statement. We would be pleased to respond to any questions.

HOW THE INFORMATION RETURNS
PROGRAM WORKS

The objective of IRP is to identify cases of unreported income. The IRP process begins with IRS receiving information returns from payers of income either directly or through the Social Security Administration (SSA). The wage and non-wage information returns are then processed and prepared for computer matching with income tax returns filed by individuals. The entire process takes approximately 17 months from the time that IRS begins to receive information returns to the time that nonfiler and underreporter notices are sent to taxpayers--(see page 36 for specific actions taken during this 17 month period).

Payers (employers, corporations, and financial institutions) are required to file information returns reporting payments made for wages, dividends, interest, and other types of income and deductions. Information returns provide the payees' names, amounts paid, types of income, and identification numbers (social security numbers which IRS refers to as taxpayer identification numbers--TINs). This information is filed either on paper or on magnetic media. With the exception of W-2 related forms, all information returns, such as Forms 1099, are received and processed by IRS. SSA receives and processes Forms W-2, which report social security and income tax withholding, wages, and tips, then forwards the documents to IRS' National Computer Center (NCC) on magnetic tape.

Information returns submitted directly to IRS by payers on magnetic media are now sent from the payers directly to NCC. At NCC, these magnetic media returns are processed, which entails various validity checks before any matching takes place. Prior

to January 1, 1985, all magnetic tapes were sent to IRS' service centers where (1) tape contents were subjected to validity checks, (2) file volume and money totals were computed for accounting purposes, and (3) tapes were reformatted to run on NCC's computers. The same processing checks are now performed at NCC.

Paper information returns are still filed and initially processed at the service centers. The documents are manually screened, and then for the most part electronically scanned and transcribed to magnetic tape using Optical Character Recognition (OCR) equipment. The tapes created by the OCR process are subjected to validity checks on the service center computers, reformatted, and shipped to NCC for further processing and matching.

During the magnetic media processing at NCC and paper/OCR processing at the service centers and NCC, information returns are eliminated for various reasons. For example, information returns that report income for businesses are eliminated because IRS does not have a business match program.

Once all IRP information is received and processed, NCC performs computer matching or correlation runs that match information returns data against tax return data filed by individuals. The match identifies cases where taxpayers have either underreported their income on filed tax returns or not filed a return. The documents are actually matched by associating the social security number on the income tax return with the social security number (or taxpayer identification number) on the information return and then comparing certain information. The computer identifies underreporter cases if (1) the amount reported on the information returns does not match what the individual reported on the income tax return and (2) the discrepancy has the potential for a tax adjustment which is greater than a predetermined amount. Nonfiler cases which

meet a minimum dollar tolerance for potential tax change are also identified.

After the correlation is completed, National office staff perform subsequent analyses on the underreporter cases to select the actual cases for follow-up at the service centers. Once National Office staff members select which underreporter cases will be forwarded to the service centers for follow-up, the tapes containing those cases, as well as all of the nonfiler cases which meet a minimum tolerance level, are identified at NCC and sent to each center. The underreporter and nonfiler cases are then followed up on by service center staff.

The underreporter work load is handled at each service center in three phases.

--During phase I, cases are subjected to an in-depth review to determine if the income in question was actually not reported. If the income is located on the tax return, the case is closed. If it cannot be determined that the income in question was reported, IRS sends the taxpayer a notice (called a CP-2000) that proposes a change to income, payments, or credits. Taxpayers are given 60 days to respond to the notice. In some instances involving complex issues, the case will be referred to Examination to determine disposition.

--Phase II consists of following up on taxpayer responses to the notices. Taxpayers will fully agree, partially agree, disagree, or not respond to the notice. In some cases, taxpayers provide sufficient explanation to account for the discrepancy. These cases are closed with no change to the original tax liability. All disagreed cases are transferred to Examination for resolution.

--Phase III involves following-up on cases in which the taxpayer did not respond to the notice or the notice was returned as undeliverable. For these cases, IRS issues a statutory notice which tells the taxpayer to pay the tax deficiency and informs him of his right to contest the deficiency by filing a petition before the United States Tax Court. If the taxpayer does not respond to the statutory notice or does not file a petition with the Tax Court, IRS will assess the full amount of the deficiency, at which time the case becomes a collection matter.

For nonfiler cases shipped to the service centers, a series of up to three notices are sent to taxpayers requesting them to file their tax returns. Prior to mailing, the Service Center Collection Branch will review notices for accuracy and legibility.

There is a 5 week interval between the first and second notices, and a 6 week interval between the second and third notices. Some cases are eliminated after the second notice because they have a lower potential yield than other cases that are present. Other cases are eliminated if the taxpayer supplies a legitimate reason for not filing. Approximately 3 weeks after the third notice, no response cases are transferred to the Automated Collection System where phone calls are made to taxpayers in an attempt to obtain their tax returns. If, after the second call, the taxpayer has not filed and if sufficient information is available on the taxpayer's income, IRS will prepare a substitute return and assess any taxes due. All other no response cases are forwarded to the field for collection officer contact.

ILLUSTRATION OF TIMEFRAMES FOR
INFORMATION RETURNS PROGRAM PROCESSING

January-December 1985	Tax year covered by wage and non-wage income
January 31, 1986	Copy of information returns due to employees and payees
February 28, 1986	Employers/payers submit W-2s to SSA and 1099s and other information returns to IRS
March-November 1986	IRS service centers convert paper information returns to magnetic media tapes and send the tapes weekly to NCC
April 1986-January 1987	Social Security transcribes Forms W-2 to tape which are sent weekly to NCC
April 1986-September 1986	Social Security sends no-TIN and invalid TIN Forms W-2 to IRS for TIN perfection
April 1986-January 1987	NCC performs edit and validity checks weekly on tapes received from SSA, IRS service centers, and various payers
January 1987	NCC prepares files for matching
April 1987-May 1987	NCC performs IRP correlation (matching) runs
May 1987	NCC sends underreporter and nonfiler cases to service centers for follow-up
June 1987-November 1987	Service centers receive and work underreporter cases
July 1987	Service centers receive and send notices for potential nonfiler cases

MAJOR TYPES OF INFORMATION
RETURNS RECEIVED BY IRS
AND USED FOR MATCHING

<u>Form Number^a</u>	<u>Title</u>	<u>Payers^b</u>	<u>Estimated Number of Documents Received For Tax Year 1983 (in millions)</u>
1098	Mortgage Interest Statement	Banks and Mortgage Companies	c
1099-A	Acquisition or Abandonment of Secured Property	Various Entities	c
1099-B	Proceeds from Broker and Barter Exchange Transactions	Brokers	10
1099-G	Certain Government Payments	State Governments	36
1099-INT	Interest Income	Banks	296
1099-DIV	Dividends	Corporations, Brokers	82
1099-MISC	Miscellaneous Income, e.g. Rents and Royalties	Various Entities	39
1099-OID	Original Issue Discount	Corporations, Banks and other Financial Institutions	2
1099-PATR	Taxable Distributions Received from Cooperatives	Cooperatives	2
1099-R	Total Distributions from Profit-Sharing, Retirement Plans, Individual Retirement Accounts, etc.	Various Entities	6
1099-SSA	Social Security Benefits	Social Security Administration	c
1099-RRB	Tier 1 Railroad Retirement Benefits	Railroad Retirement Board	c
W-2G	Certain Gambling Winnings	Gambling Establishments	1
W-2	Wage and Tax Statement	Employers	165
W-2P	Annuities, Pensions, Retired Pay, or IRA Payments	Various Entities	18
5498	Individual Retirement Account Information	Banks, Insurance Companies, Brokers	18
Various	Foreign Documents for Income Paid to U.S. Citizens, such as Dividends, Interest	Foreign Entities	1
K-1	Shareholder's, Partner's, or Beneficiary's Share of Income, Credits and Deductions	Partnerships	15

^a Forms 1098, 1099-A, 1099-B, 1099-G, 1099-SSA, and 1099-RRB are new since tax year 1983.

^b Payers listed for each return may not be all inclusive.

^c These returns were not received for tax year 1983.

MAJOR LEGISLATION AFFECTING THE
INFORMATION RETURNS PROGRAM

Public Law 87-397 (enacted in 1961)--This law required taxpayers to provide IRS and payers with a taxpayer identification number--typically a social security number--and established civil penalties for those who failed to do so. This law was instrumental to the IRP Program because it facilitated the use of automated data processing equipment by IRS, and enabled IRS to effectively match information returns to their respective income tax returns.

Revenue Act of 1962 (Pub. L. No. 87-834)--In this Act, Congress recognized that the underreporting of dividend and interest income on tax returns was a serious problem. To correct the problem, this Act substantially expanded the information returns reporting requirements for interest and dividend income. Further, the Act required payers to furnish copies of the information returns to the taxpayers receiving dividend and interest income; and strengthened the penalty provisions for information returns.

Combined Old-Age, Survivors, and Disability Insurance-Income Tax Reporting Amendments of 1975 (Pub. L. No. 94-202)--Under this law, IRS and the Social Security Administration (SSA) were directed to create and implement an annual wage reporting system to reduce the reporting burden on taxpayers. This system, known as Combined Annual Wage Reporting, had a dramatic impact on IRP by allowing IRS to take better advantage of machine processing efficiency. This was possible because SSA had the equipment and capacity, which IRS did not, to process a large volume of Forms W-2.

The Economic Recovery Tax Act of 1981 (Pub. L. No. 97-34)--Before 1981, a payer who was required to file an information return with IRS, generally did not have to furnish a copy to the taxpayer. This Act expanded the requirement that payers furnish information returns to the taxpayer to whom the payment on the return relates. Moreover, the Act increased the penalty for failure to furnish copies of such returns to the taxpayer and increased the penalty for failure to file certain information returns with IRS.

The Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248)--This Act expanded information reporting to include such items as state and local income tax refunds, and proceeds from brokers and barter exchanges. The Act also imposed mandatory 10 percent withholding on such things as interest, dividends, patronage dividends, and original issue discount. The Act also expanded and increased the penalties for (1) failure to file information returns, (2) failure to provide copies to payees, and (3) failure to provide a payer and/or payee TIN. In certain instances, where a payee failed to provide a correct TIN to a payer, the Act required backup withholding at a rate of 15 percent. Finally, the Act authorized the Secretary of the Treasury to prescribe regulations providing standards for determining which returns must be filed on magnetic media.

Interest and Dividend Tax Compliance Act of 1983 (Pub. L. No. 98-67)--This legislation repealed the mandatory withholding requirements of the Tax Equity and Fiscal Responsibility Act of 1982. In place of the 10 percent mandatory withholding requirement, the Act expanded and revised the system of backup withholding, strengthened TIN and failure to file penalties, and expanded the coverage of magnetic media filing requirements.

Generally, as a result of this Act, backup withholding is required at a rate of 20 percent if (1) the payee does not furnish the payer with a TIN, (2) IRS notifies the payer that the TIN is incorrect, (3) the payee underreports dividend or interest and IRS notifies the payer, or (4) the payee does not properly certify that he or she is not subject to backup withholding for interest and dividend income and that the TIN provided to the payer is correct.

Tax Reform Act of 1984 (Pub. L. No. 98-369)--This Act required new information reporting for such items as foreclosures and abandonments of property which secure indebtedness and for mortgage interest, and provided penalties for failure to file and furnish such returns.

INFORMATION RETURNS
RECEIVED, PROCESSED, AND
MATCHED BY IRS
(in millions)^a

	Tax Year					<u>Totals</u>
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	
Received	563.6	588.2	623.6	633.6	694.7	3,103.7
Processed	491.8	527.0	559.4	568.4	634.6	2,781.2
Percent of Total Receipts Processed	87	90	90	90	91	90
Matched	450.2	473.1	494.4	508.0	541.3	2,467.0
Percent of Total Receipts Matched	80	80	79	80	78	79

^a Figures are rounded.

UNDERREPORTER CASES IDENTIFIED,
ELIMINATED AND FOLLOWED UP
ON FOR THE PERIOD 1979 THROUGH 1982a

	Tax Year				<u>Totals</u>
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	
Number of Cases Identified	9,409,000	8,091,000	9,705,000	8,457,000	35,662,000
Number of Cases Eliminated ^b	6,198,000	2,777,000	4,561,000	1,032,000	14,568,000
Percent of Identified Cases Eliminated	66	34	47	12	41
Number of Cases Followed Up ^c	3,033,000	4,996,000	4,886,000	7,066,000	19,981,000
Screened Out ^d	1,800,000	2,159,000	2,660,000	2,967,000	9,586,000
Notices Sent	1,233,000	2,837,000	2,226,000	4,099,000	10,395,000
Percent of Identified Cases Resulting in Notices	13	35	23	48	29

a Underreporter cases are generated when the amount of income reported on the tax return is less than the amount on the information return and the difference could result in a potential tax change higher than a predetermined tolerance level.

b Cases are "eliminated" by IRS based on its comparative analysis of potential tax adjustment, cost, and available resources.

c IRS considers "cases followed-up" as those that are screened out after reviewing the tax return and those that are followed-up with a notice.

d Cases are screened out because the suspected underreported amount is found on the tax return or the case is judged to be of low potential because of information contained on the tax return.

INFORMATION RETURNS PROGRAM
NONFILER CASES
(in millions)

Tax Year

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Cases generated	2.4	2.3	2.9	2.8	3.0 ^a	3.3 ^a
Tax returns filed after follow-up	.9	1.2	1.2	b	b	b

^a IRS' estimated figures.

^b Statistics are unavailable.

INFORMATION RETURNS PROGRAM
ASSESSMENTS AND PENALTIES^a
(in \$ millions)

Tax Year

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Net Assessments And Penalties ^b	727	695	1,514	1,434	2,352	2,711 c	2,931 c
Program Costs	90	84	107	116	135	154 c	187 c
Yield to Cost Ratio d	8	8	14	12	17	18 c	16 c

- ^a Includes underreporter and nonfiler cases closed in returns processing and examination.
^b Figures are for dollars assessed and do not reflect actual dollars collected.
^c IRS' estimates.
^d Rounded to nearest whole number.

SCHEDULE K-1 RETURNS
RECEIVED AND MATCHED

	<u>Tax Year</u>					
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>Totals</u>
Number Received	11,078,000	11,835,000	14,119,000	15,334,000	16,533,927	68,899,927
Number Matched	1,841,000	2,082,000	1,052,000	2,237,000	2,900,463	10,112,463
Percent Matched ^a	17	18	7	15	18	15

^a Rounded to nearest whole number.