United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations, House of Representatives

May 1988

TAX ADMINISTRATION

IRS Could Reduce the Number of Unproductive Business Nonfiler Investigations

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The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the Internal Revenue Service's (IRS) efforts to identify and investigate businesses that do not file required tax returns. The report contains recommendations for IRS on reducing unproductive investigations and detecting business nonfilers.

As agreed with your Subcommittee, we plan no further distribution of this report until 14 days from the date of issuance, unless you publicly announce its contents earlier. At that time, we will send copies to the Commissioner of Internal Revenue and other interested parties.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Assistant Comptroller General

Executive Summary

Purpose

Each year many businesses fail to file one or more required tax returns—income, employment, and excise. The Internal Revenue Service (IRS) investigates such nonfiling and, in fiscal year 1986, it completed 3.7 million business nonfiler investigations and assessed about $5.9 billion in taxes. However, IRS closed about 73 percent of the investigations without obtaining returns and assessing taxes.

At the request of the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO reviewed IRS' efforts to detect business nonfilers, with emphasis on ways IRS could reduce the number of unproductive investigations. GAO defines an unproductive investigation as one where IRS finds that a business filed the proper return or owed no taxes.

Background

IRS identifies most potential business nonfilers through a computerized delinquency check program. This program matches tax returns filed to the types of returns each business is required to file as recorded on IRS' business master file. When no match occurs, IRS classifies the business as a potential nonfiler and sends the business up to three computer-generated notices seeking the delinquent return. If the business does not respond or responds unsatisfactorily, IRS personnel may telephone or visit the business to obtain the delinquent return. If the return still is not obtained, IRS can assess penalties and taxes based on the business' last reported tax liability.

Results in Brief

GAO randomly selected and analyzed a sample of 1,976 business nonfiler investigations closed in fiscal year 1987. Although the results cannot be projected, IRS officials believed that the results would generally reflect why many investigations were unproductive. GAO found the following:

- In 15 percent, or 298 cases, IRS erroneously issued multiple employer identification numbers to businesses that filed the questioned return under only one of the numbers.
- In 19 percent, or 369 cases, businesses did not follow IRS regulations to file employment tax returns when no tax was owed.

GAO also found that in about 16 percent, or 317 cases, the case files showed that IRS did not accurately update the master file with the results of the nonfiler investigations. In these instances, IRS did not delete invalid filing requirements or incorrectly deleted valid requirements from the master file. Inaccurate filing requirements will likely result in future unproductive investigations or decrease the likelihood of IRS detecting future nonfilers.

IRS could reduce unproductive investigations by not issuing multiple employer identification numbers, emphasizing to businesses the importance of filing required employment tax returns, using the results of nonfiler investigations in deleting invalid employment tax filing requirements, and ensuring the filing requirements recorded on IRS' master file are accurate.

Principal Findings

Employers Receiving Multiple Identification Numbers

IRS policy is to issue only one employer identification number to each business and IRS generally expects to receive tax returns for each issued identification number. If IRS erroneously issues more than one number, the business will be identified and investigated as a potential nonfiler even if it filed the required tax returns under one of the numbers. (See pp. 14 to 15.)

In 15 percent of GAO's sample cases, IRS issued more than one identification number because IRS' research techniques did not always identify previously issued numbers. Use of expanded research techniques already tested successfully in some IRS locations such as using variations of a business' name, would help to reduce the issuance of multiple employer identification numbers. (See pp. 15 to 16.)

IRS can also identify businesses with previously issued identification numbers by actively pursuing the receipt of Form SS-4. When IRS issues an identification number, it sends a Form SS-4 to the business to complete and return. The form identifies whether the business already has an identification number. In a limited test, GAO looked at 600 returned Form SS-4s and found that 35 percent of the businesses told IRS that they already had a number. Even though completed SS-4s can help lessen the number of unproductive investigations, IRS generally does not monitor and pursue the receipt of the forms. (See pp. 16 to 17.)

Businesses Not Following Filing Requirements

In order to monitor compliance, IRS requires businesses, even if they have no employees and owe no taxes, to file four consecutive quarterly employment tax returns. When a business does not file required returns, IRS automatically initiates a nonfiler investigation. If IRS receives four consecutive quarterly returns showing no tax liability, IRS notifies the business not to file again until it has employees and owes taxes. IRS also deletes the business' filing requirement from the business master file, which avoids an unproductive investigation. (See p. 17.)

In about 19 percent of GAO's sample of 1,976 cases, IRS conducted unproductive investigations because businesses failed to file required quarterly returns when they owed no taxes. IRS may get more businesses to file by revising return instructions and nonfiler notices to emphasize the importance of filing quarterly returns until IRS says otherwise. (See pp. 17 to 19.)

In deciding whether to remove the filing requirement from the master file, IRS only considers quarterly returns filed by the businesses. IRS does not consider quarters in which the nonfiler investigations disclosed no taxes were owed. Inclusion of these quarters would help to prevent additional unproductive investigations. (See pp. 18 to 19.)

Filing Requirements Are Not Accurately Maintained

IRS' business master file contains information on which types of returns IRS believes a business should be filing. If this information is inaccurate, IRS may conduct a nonfiler investigation when it should not or fail to conduct an investigation when it should. (See pp. 19 to 20.)

In about 16 percent of GAO's sample cases, IRS did not use information from the nonfiler investigations to accurately maintain the master file. In about 10 percent of the cases, invalid filing information was not deleted. For example, IRS determined from the nonfiler investigation that a business was no longer required to file corporate income tax returns but did not remove the requirement from the master file. (See p. 20.)

In 6 percent of the cases, valid filing information was deleted. For example, IRS determined from the nonfiler investigation that a business was still required to file employment tax returns but removed the requirement from the master file. Neither GAO nor IRS could fully determine why the inactions and incorrect actions occurred. (See pp. 20 to 21.)

Recommendations

To reduce the number of unproductive nonfiler investigations, GAO recommended that the Commissioner of Internal Revenue

- adopt additional research techniques, such as using variations of the business name and the actual signature name on the return, and actively pursue the receipt of Forms SS-4 to identify businesses with previously issued employer identification numbers;
- revise employment tax return instructions and business nonfiler notices to emphasize to businesses the importance of filing required quarterly employment tax returns;
- modify criteria for deleting invalid employment tax filing requirements to include the results of nonfiler investigations; and
- ensure that the filing status determined from nonfiler investigations is accurately recorded on the business master file.

Agency Comments

IRS agreed with GAO's recommendations and is taking actions to implement them. (See p. 22.)

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Abbreviations

ACS	Automated Collection System
EIN	Employer Identification Number
GAO	General Accounting Office
IRS	Internal Revenue Service

Introduction

Each year many businesses fail to file one or more required tax returns. To maintain the integrity of our Nation's voluntary compliance tax system and to collect taxes owed, it is important that the Internal Revenue Service (IRS) identify these business nonfilers and obtain their delinquent tax returns.

IRS' Collection Division has overall responsibility for detecting potential business nonfilers, obtaining the delinquent returns, and collecting any taxes owed. In fiscal year 1986, IRS closed about 3.7 million business nonfiler investigations[1] that cost an estimated $87.5 million, or about $24 each. IRS closed 73 percent of the investigations without obtaining returns because the businesses did not owe any taxes, could not be located, had already filed the questioned returns, or were judged by IRS to have little tax potential. IRS closed the remaining 27 percent by obtaining a tax return. That is, businesses filed the returns in response to IRS' nonfiler investigation. According to IRS, the tax assessments generated from these investigations totaled about $5.9 billion. Information was not readily available to determine how much of this amount was actually collected.

At the request of the Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, we reviewed IRS' efforts to detect and investigate business nonfilers, with emphasis on ways IRS could reduce unproductive investigations. For the purpose of this report, we define unproductive investigations as those where IRS' investigations of potential nonfilers could have been avoided because the businesses either filed the proper returns or owed no taxes.

Tax Returns Filed by Businesses

Businesses are required to file as many as three types of tax returns—income, employment, and excise. Every business must file an income tax return annually. The specific income tax form used by a business depends on its organizational structure. For example, corporations file Form 1120, partnerships file Form 1065, and sole proprietorships file Form 1040 with appropriate business schedules.

Businesses with employees are required to file employment tax forms and pay employment taxes, such as federal income taxes withheld from

[1]The term investigation as used in this report includes notices sent to taxpayers, as well as IRS telephone or personal contacts with taxpayers to obtain the delinquent returns. Through these investigations, IRS obtains information necessary to determine whether businesses owe taxes, but the investigations do not necessarily result in delinquent returns being filed when no taxes are owed.

employees' wages, social security taxes, and federal unemployment taxes. For withheld income taxes and social security taxes, the businesses must file Form 941 quarterly; for agricultural employees the businesses must file Form 943 annually; and for unemployment taxes the businesses must file Form 940 annually.

Businesses engaged in certain types of activities are required to file excise tax returns. The tax returns for and periods covered by excise taxes vary by type of activity. Excise taxes generally fall into five categories: (1) facilities and services, such as telephone communication and air transportation; (2) various manufactured products, such as sporting equipment and gasoline; (3) retail sales and use of certain motor fuels and heavy equipment; (4) windfall profits from production of domestic crude oil; and (5) certain business operations that can harm the environment.

How IRS Identifies Potential Business Nonfilers

IRS has several methods of identifying potential business nonfilers, but program officials estimate that over 95 percent of potential business nonfilers are identified through the computerized delinquency check program. This program matches the business tax returns filed to that business' filing requirements recorded on IRS' business master file. IRS establishes the types of returns the business is required to file when the business is issued an employer identification number (EIN). If the program identifies a business that has a filing requirement but no corresponding return, the business is classified as a potential nonfiler.

Potential business nonfilers are also identified by other IRS components, such as the Examination and Criminal Investigation Divisions, in the course of their normal duties. These components refer cases to the Collection Division for resolution. In addition, potential business nonfilers are identified through special compliance projects that target specific industries or businesses in a geographic area.

How IRS Investigates Potential Business Nonfilers

Once potential business nonfilers are identified, IRS attempts to obtain the delinquent returns using a three-stage process. In the first stage the appropriate IRS service center sends a series of computer-generated notices to the potential business nonfiler. If the business does not respond to the first notice within a specified amount of time, a second notice is sent. Depending on IRS' estimate of the business' potential tax liability, the inquiry may be dropped after the second notice with no further follow-up, or the nonresponding business is sent a third and final notice. This first-stage process can take 22 weeks or more.

If the business responds to any of these notices, tax examiners within the service center collection function analyze the response. If the business files the required return or the tax examiner is satisfied that a return is not required, the case is closed and no further action is taken. If the tax examiner is not satisfied with the business' response, IRS service center personnel attempt to obtain additional information from the business or from other internal IRS data such as information contained on the business master file account to resolve the case. If the business does not respond to the notices or service center tax examiners cannot resolve the case, it is transferred to the Automated Collection System (ACS) for telephone follow-up.

In the second stage, the service centers use the potential business nonfiler's last known zip code to assign the case to an ACS tax examiner at the appropriate call site. IRS has 21 call sites located throughout the country from which IRS tax examiners can phone potential business nonfilers. The tax examiner attempts to identify the business' current address and telephone number. If this information is obtained, the tax examiner then phones the business to resolve the potential delinquency and/or secure the delinquent returns. If the tax examiner obtains sufficient information to resolve the potential delinquency, the case is closed. If the ACS tax examiner cannot resolve the case, it is usually transferred to an IRS district office for further investigation.

In the third stage, a district office revenue officer visits the potential business nonfiler's last known address. If the business is no longer located at that address, the revenue officer may use third-party information including, but not limited to, neighborhood interviews and record checks with federal, state, and local government agencies to find the business. If the business is located, the revenue officer usually visits the site to resolve the potential delinquency and/or obtain all delinquent returns or gather sufficient information to prepare substitute returns[2] for the delinquent periods. If the business cannot be located and the revenue officer lacks sufficient information to prepare a substitute return, the investigation is suspended indefinitely pending future information on the location of the business.

[2]IRS has authority to prepare substitute returns for delinquent businesses and assess taxes when the business fails to respond to the nonfiler notices and IRS determines that a potential tax liability exists based on prior tax liabilities and other available information.

Objectives, Scope, and Methodology

In March 1987, we testified[3] before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, on, among other things, the potential effectiveness of using information returns to detect business nonfilers. These are returns filed by third parties such as banks showing interest, dividends, and other types of income paid to businesses. As a result of these hearings, IRS agreed to determine the costs and benefits of using information returns to detect business nonfilers. In addition, the Chairman requested that we continue reviewing IRS' efforts to detect business nonfilers, focusing on ways IRS could reduce the number of unproductive investigations.

To determine why many business nonfiler investigations are unproductive, we (1) obtained and analyzed information on IRS' nonfiler policies and procedures; (2) discussed program operations with IRS officials and state government officials familiar with the business nonfiler issue; (3) analyzed various IRS management information reports and available studies on the nonfiler issue; (4) analyzed a random sample of 1,976 business nonfiler investigations closed in fiscal year 1987 by IRS service centers, ACS call sites, or district offices; and (5) analyzed information from the business master file and other case documents for all sampled investigations.

In addition to our work at IRS' National Office, we selected three IRS Regional Offices—Southeast, Western, and North Atlantic—that had among the highest levels of nonfiler investigations in fiscal year 1986. In these regions, we visited the San Francisco, Sacramento, Atlanta, Jacksonville, Manhattan, and Newark district offices; the Oakland, Atlanta, Jacksonville, Manhattan, and Newark ACS call sites; and the Fresno, Atlanta, and Brookhaven Service Centers. To determine whether the nonfiler program affected state programs, we visited state agencies in the geographical areas where we did our work. These agencies included the California State Franchise Tax Board, Board of Equalization, and Employment Development Department; the Georgia State Department of Revenue; and the New York State Department of Taxation. We also did work at the Social Security Administration's National Office to determine how IRS' nonfiler program affected other federal programs that rely on businesses filing required employment tax information.

We selected our sample of 1,976 closed cases from each of the nonfiler investigation stages including (1) the two service center

[3] Statement of Jennie S. Stathis, U.S. General Accounting Office, entitled The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, Mar. 17, 1987).

functions[4] in the notice stage, (2) the ACS function in the telephone stage, and (3) the district office function in the field visit stage. Table 1.1 presents the locations and functions from which our samples were drawn.

Table 1.1: Sample of Business Nonfiler Investigations Closed Between November 1986 and May 1987

	Location and Number of Cases Sampled			
Function	**North Atlantic Region**	**Southeast Region**	**Western Region**	**Total**
Service Center				
Code and Edit	216	205	225	**646**
Research	120	153	192	**465**
ACS Call Site	106	112	239	**457**
District Office	92	120	196	**408**
Total	**534**	**590**	**852**	**1,976**

The North Atlantic Region sample included nonfiler investigations closed by the Brookhaven Service Center, the Manhattan and Newark ACS Call Sites, and the Manhattan District Office. The Southeast Region sample included nonfiler investigations closed by the Atlanta Service Center, Atlanta and Jacksonville ACS Call Sites, and the Atlanta District Office. The Western Region sample included nonfiler investigations closed by the Fresno Service Center, Oakland and Laguna Niguel ACS Call Sites, and the San Francisco District Office.

The results of our analysis of sample cases are not projectable. Our sample universe had to be restricted to recently closed cases because IRS retains nonfiler case documentation for only a limited period. Accordingly, our sample was drawn from nonfiler investigations closed between November 1986 and May 1987 and may not adequately represent the nonfiler work load in other periods. IRS officials agreed with our sampling methodology and said that even though the results are not projectable, the results obtained would be generally reflective of IRS' business nonfiler detection efforts. IRS officials also reviewed and verified our conclusions on each case that we classified as an unproductive investigation.

We did our work between March and October 1987 in accordance with generally accepted government auditing standards.

[4]These functions are the code and edit function and the research function. The code and edit function closes cases based on the businesses' responses without additional research, while the research function closes cases based on the businesses' responses coupled with additional research.

Unproductive Business Nonfiler Investigations Can Be Reduced

Many of IRS' business nonfiler investigations are unproductive. Our analysis of 1,976 randomly selected business nonfiler investigation cases closed during fiscal year 1987 identified reasons why investigations were unproductive.

- In 15 percent, or 298 cases, IRS erroneously issued multiple employer identification numbers (EIN) to businesses that filed the questioned return under only one of these numbers.
- In 19 percent, or 369 cases, businesses did not follow IRS regulations to file employment tax returns when no tax was owed. Apart from these reasons, we found that in 317 cases, or about 16 percent[1] of our sample, the case files showed that IRS did not delete invalid filing requirements (i.e., required type of returns a business should file) or incorrectly deleted valid requirements from the business master file. Not deleting invalid requirements will likely result in future unproductive investigations. Deleting valid requirements, on the other hand, decreases the likelihood of IRS detecting business nonfilers. We did not find these problems in the remaining sampled investigations.

IRS could reduce the number of unproductive investigations by (1) adopting additional techniques for researching and issuing EINS, (2) revising employment tax return instructions and nonfiler notices to emphasize to businesses the importance of filing required quarterly returns, (3) using the results of closed nonfiler investigations in deleting invalid employment tax filing requirements, and (4) ensuring that the business' filing requirements are accurately recorded on the master file.

Multiple EINs Cause Unproductive Investigations

About 15 percent of our sample investigations were unproductive because IRS erroneously issued multiple EINS to businesses. IRS issued multiple EINS to these businesses because its research techniques did not identify previously issued EINS. IRS could reduce the incidence of multiple EINS by adopting additional research techniques to identify businesses with previously issued EINS and actively pursuing the receipt of Form SS-4, "Application for Employer Identification Number."

[1] The percentages shown—15, 19, and 16 percent—should not be added because some cases fall into more than one category.

Why Multiple EINs Cause Unproductive Nonfiler Investigations

IRS policy is to issue one EIN to each corporation, partnership, and sole proprietorship with employees. The EIN provides the business with a unique identity for tax purposes. IRS uses the EIN to identify and track the business' tax return filing requirements and filing history. IRS expects to receive the appropriate tax returns for each EIN issued.

For each EIN issued, IRS determines the business' tax return filing requirements from the type and activities of the business and records these requirements on the master file. IRS issues EINS to businesses that (1) file a Form SS-4 or (2) file returns or make tax deposits without EINS or with incorrect EINS (e.g., EINS with transposed numbers). When IRS receives an EIN application or a tax return or tax deposit with a missing or incorrect EIN, tax examiners research IRS records to determine whether the business had previously been issued an EIN. If IRS finds the business had previously been issued an EIN, it notifies the business to that effect. If IRS cannot find an active EIN for the business, IRS will issue an EIN and request that the business complete Form SS-4.

We found that IRS erroneously issued some businesses multiple EINS. In about 15 percent, or 298 of our sample cases, IRS had issued multiple EINS to businesses, which later resulted in unproductive nonfiler investigations. When IRS erroneously issues more than one EIN to a business, the business will be identified and investigated as a potential nonfiler because the business uses only one of the EINS on its filed tax returns. IRS will post the tax return information to that EIN on the master file. Any other EINS issued to the business will not have a corresponding tax return associated with them on the master file. Consequently, IRS' computer program will identify the other EINS as belonging to potential nonfilers, triggering unproductive investigations. A 1983 IRS advisory report, Service Center Collection Branch Study, also found that erroneously issued EINS were a major contributor to unproductive nonfiler investigations.

In addition to creating unproductive investigations for IRS, multiple EINS also confuse and create extra paperwork for businesses and government agencies that rely on IRS-issued EINS in their processing operations. For example, in responding to an IRS nonfiler notice, one sampled taxpayer wrote that the business had filed the questioned return under another EIN and had notified IRS several times about being issued two EINS. Also, Social Security Administration and New York State Department of Taxation officials told us that multiple EINS hamper their operations. Social Security National Office officials indicated that their cost of reconciling wage information reported to them with that reported to IRS increases when multiple EINs are issued. A New York State Department of Taxation official said that, like IRS, they have a business nonfiler detection program that uses IRS-issued EINs for identification purposes. When a New York business files its state tax return using a second EIN, the department may identify the business as a potential nonfiler and conduct an unproductive investigation because a tax return was not filed using the first EIN.

IRS Research Could Be Expanded to Help Identify Previously Issued EINs

IRS issued multiple EINs because its research techniques did not identify that the businesses previously had been issued EINs. Internal Revenue Manual section 3(13)22.2 requires service center tax examiners to compare the business name and address on tax returns with missing or invalid EINs to the business name and address on the business master file to identify whether the business had previously been issued an EIN. According to an IRS training manual, tax examiners should use the first 10 characters of the business' name and the first 3 digits of its zip code shown on the tax return for this purpose. These characters, including spaces and digits, must match exactly with the name characters and zip code digits recorded in the master file for the computer to identify a possible match.

This research technique does not enable IRS to always identify businesses with previously issued EINs. When businesses do not use the exact name and/or address on their tax returns that is recorded on the master file, an exact match cannot be made. In such cases, IRS will issue the business another EIN. For example, IRS issued a business a second EIN because the business name on the tax return was shown as one word, but the business name on IRS' master file was recorded as two words (i.e., "JohnDoe" versus "John Doe").

IRS could improve its research techniques to better identify businesses with previously issued EINs. Current research techniques could be expanded to include things such as matching the names of all the business owners and using variations in the spelling and punctuation of the business name. Studies at the Brookhaven and Fresno Service Centers have concluded that these expanded research techniques could help identify more businesses with previously issued EINs. Officials from the two centers said they have started using these expanded techniques.

In contrast, Atlanta Service Center tax examiners do not use expanded research techniques. To test the merits of expanded research techniques, we had Atlanta tax examiners research a separate sample of 97 returns that were recently filed without EINS or with incorrect EINS. First the tax examiners used the standard techniques (i.e., first 10 characters of the name and first 3 digits of the zip code) to search, at computer terminals, for previously issued EINS. If an EIN was not identified with the standard techniques, the tax examiners used expanded techniques. These techniques included researching name variations and the actual signature name on the return. For example, if the name on the return was "Smith and Jones" partnership they also researched the master file using "Jones and Smith" partnership. Similarly, if the name on the return was "John Autobody" and the signature on the return was "John Doe," they also researched the master file for "John Doe Autobody." Although most of the 97 businesses appeared to need an EIN, the use of expanded research techniques allowed IRS to identify 12, instead of 7, businesses with previously issued EINS, which prevented five additional unproductive investigations.

Fresno and Atlanta officials said the additional time required to perform the expanded research was minimal. A Fresno official estimated that the expanded techniques took at most 3 minutes longer than the standard procedures, while an Atlanta official estimated they took 1 to 1-1/2 extra minutes per case. In addition, a Brookhaven official, responsible for returns processing, said that the use of these expanded techniques would not disrupt their returns processing. Even though the time required to perform expanded research appears to be minimal, IRS has not established a nationwide policy on using expanded research techniques.

Pursuit of Form SS-4 Would Help Identify More Multiple EINs

In addition to expanding research techniques, IRS could identify businesses with previously issued EINS by more actively pursuing the receipt of Form SS-4. When IRS issues an EIN to a business that filed a return without an EIN or with an incorrect EIN, IRS also requests that the business complete Form SS-4. The Form SS-4 provides IRS with the information needed to establish filing requirements and alerts IRS of businesses that have previously been issued EINS. IRS expects the business to complete and return the form within 15 days. When the business returns the form, IRS uses the information to correct the issuance of multiple EINS.

Businesses with previously issued EINS are frequently identified when they return Form SS-4. We asked the Atlanta, Brookhaven, and Fresno Service Centers to provide us a sample of SS-4s that businesses had recently completed and returned in response to IRS' request. Of these, we selected and analyzed 600 SS-4s. Our analysis showed that 35 percent, or 212 businesses, informed IRS that they already had an EIN and did not need a new one. IRS had used this information to delete the additional EINs from the master file accounts, which prevents these businesses from being erroneously identified as nonfilers.

Despite the value of the Form SS-4 for identifying businesses issued multiple EINS, IRS service center personnel told us they generally do not monitor and pursue the receipt of these forms. At our request, the Fresno Service Center provided some data that we used to estimate the return rate for Form SS-4 for the period May 1986 through April 1987. Our analysis showed that of the forms that the Fresno Center sent to businesses, approximately 21 percent of the forms were not returned.

Businesses Not Following Filing Requirements Cause Unproductive Investigations

Unproductive nonfiler investigations can also be attributed to businesses not following IRS regulations and instructions regarding employment tax returns. For example, in 19 percent, or 369, of 1,976 sampled cases, the business did not file employment tax returns as required. IRS could reduce unproductive investigations of this type by (1) emphasizing to businesses the importance of filing required quarterly employment tax returns even though no taxes are owed and (2) modifying its computer program for deleting invalid employment tax return filing requirements.

For administration and compliance purposes, once an employment tax return filing requirement has been established, IRS Regulation Section 31.6011(a)-4(a) requires that every person required to make a return of income tax withheld from wages must file such returns each quarter whether or not wages are paid during that quarter.

Furthermore, IRS' instructions to Form 941—the employment tax return form—clarify this regulation by stating

> "If you temporarily stop paying wages or your work is seasonal, file a return for each quarter. Do this even though you have no taxes to report. But if you go out of business or stop paying wages [permanently], file a final return."

Requiring businesses to file returns even though no taxes are owed allows IRS to detect employment tax return nonfilers through the computerized delinquency check program. Without such filing requirements, IRS would not have sufficient information to monitor businesses' compliance with employment tax laws. Even though IRS regulations and instructions require such filings, some businesses do not always comply with them. The existing penalty for not filing employment tax returns is ineffective because it is based on the tax liability. If no tax liability exists, a penalty cannot be imposed.

IRS has recognized that unproductive nonfiler investigations occur because some businesses do not file employment tax returns when no taxes are due. A November 1983 IRS Office of Evaluation and Research report entitled TDI (Taxpayer Delinquency Investigation) STUDY concluded that the requirement to file returns when wages are not paid may be overlooked by businesses, especially seasonal businesses, causing needless investigations. The study recommended that IRS "highlight" in the Form 941 instructions that seasonal businesses that temporarily stop paying wages must file even though no taxes are owed. In addition to highlighting the Form 941 instructions, we believe that including similar information on nonfiler notices could further help reduce unproductive nonfiler investigations. We noted that the California State Employment Development Department includes such information in its nonfiler notices. These notices state that the businesses must file the returns even though they have no tax liability. According to an official of this department, including this information has helped to avoid unproductive investigations.

To further impress on businesses the need to file employment tax returns even when no wages have been paid, IRS could also inform businesses of the consequences of not filing their tax returns in the Form 941 instructions and subsequent nonfiler notices. IRS could explain that failing to file causes IRS and the business to waste resources in resolving the investigation and could result in IRS assessing taxes, which are usually calculated from the business' last reported employment tax liability. Correcting this assessment would require additional time and resources from both IRS and the business. A similar observation was made in a 1983 IRS study on the service center collection function. The study identified an official in a major private sector collection firm who concluded that IRS could reduce the number of unproductive nonfiler investigations by informing businesses of the actions IRS may take to resolve nonfiler investigations.

In addition to emphasizing the importance of following filing instructions, IRS could also modify its criteria for deleting invalid employment tax return filing requirements. Currently, IRS has a computer program to automatically delete employment tax return filing requirements from the business master file for businesses that file four consecutive quarterly returns with zero tax liability. While deleting these requirements, IRS' program also generates a notice that advises an affected business that it does not have to file the returns until it has employees and owes taxes.

The program does not include criteria to automatically delete the filing requirement in cases where IRS' nonfiler investigations determine the business had no tax liability. For example, if the business filed zero tax liability returns for the first and second quarter and IRS nonfiler investigations disclosed the business had no employment tax liability for the third and fourth quarter, the program would not delete the employment tax return filing requirement or notify the business not to file. IRS officials agreed that nonfiler investigations disclosing no tax liability, such as that shown in the above example, are like businesses filing zero liability returns and therefore could be used in its criteria to delete invalid employment tax return filing requirements. Our analysis showed that if the program criteria included the results of nonfiler investigations, 98 of the 369 unproductive employment tax return investigations in our sample could have been avoided.

Modifying the IRS computer program criteria to delete the filing requirement for such businesses would not be expensive. According to an IRS project analyst responsible for automated business return processing programs, modifying the computer program to consider closed nonfiler investigations would not require a major expenditure of resources. He estimated it would take one IRS programmer about 2 to 4 weeks to modify the program.

Inaccurate Filing Requirements Could Cause Unproductive and Missed Investigations

Nonfiler detection depends on IRS establishing and maintaining accurate filing requirement information on the types of returns businesses are required to file and the periods for which they are due. However, IRS employees do not always accurately maintain these filing requirements. In analyzing our sample cases, we found that IRS employees were sometimes not deleting invalid filing requirements and other times were deleting valid filing requirements from the master file. For example, the case files showed for an employment tax return nonfiler investigation that although the business was not required to file corporate income tax returns, the IRS tax examiner did not delete this filing requirement from the business master file. In another case, the business was still required to file employment tax returns but the tax examiner deleted the filing requirement from the master file. Not deleting invalid filing requirements will likely cause future unproductive nonfiler investigations. On the other hand, deleting valid filing requirements decreases the likelihood of IRS detecting potential business nonfilers.

IRS employees use various transaction codes to adjust filing requirements. These codes may delete filing requirements permanently (i.e., no longer liable), suspend filing requirements temporarily (i.e., not liable this period), add new filing requirements, merge accounts for businesses issued more than one EIN, or leave the filing requirements unchanged. The transaction codes can be entered in any of the three stages of the nonfiler investigation—the notice stage, the ACS stage, and the district office stage.

As reflected in table 2.1, we analyzed our sample of 1,976 closed cases to determine how well IRS maintains filing requirements. From reviewing the case files, we determined that IRS did not accurately maintain the filing requirements on 16 percent, or 317, of the cases sampled.

Table 2.1: Inaccurately Maintained Filing Requirements for Sample of Cases Closed Between November 1986 and May 1987

		Inaccurate Filing Requirements					
	Cases	Left open		Closed		Total	
Collection activity	sampled	Number	Percent	Number	Percent	Number	Percent
Service Centers	1,111	85	8	60	5	145	13
ACS Call Sites	457	71	15	35	8	106	23
District Offices	408	50	12	16	4	66	16
Total	**1,976**	**206**	**10**	**111**	**6**	**317**	**16**

In 10 percent of the cases, IRS did not accurately delete filing requirements that were no longer valid, and in 6 percent of the cases IRS deleted filing requirements that were still valid. Using IRS' fiscal year 1986 business nonfiler program cost data, we estimated that for 206 of our 317 inaccurately maintained cases, IRS would spend about $5,000 unnecessarily pursuing erroneous nonfiler leads because IRS employees did not use the information obtained from the business to delete inaccurate filing requirements. We could not estimate the potentially lost tax revenues associated with undetected nonfilers.

IRS officials reviewed these 317 cases and agreed that the filing requirements were not accurately maintained. About 16 percent, or 51, of the 317 inaccurately maintained cases resulted from computer terminal operators not entering the correct transaction codes. For the remaining 84 percent, or 266 cases, neither we nor IRS could specifically determine from the case files why the filing requirements were not accurately maintained. However, in the locations we visited, IRS managers responsible for the nonfiler program and supervisors who reviewed the results of our sampled cases offered the following explanations as to why the filing requirements may not have been accurately maintained:

- IRS manuals are too general in that they do not specifically instruct revenue officers and tax examiners how to properly maintain filing requirements.
- ACS tax examiners are not required to update filing requirements for returns and/or periods not under investigation.
- Nonfiler investigations are a low priority for revenue officers, and therefore they may not be familiar with the transaction codes used to maintain the filing requirements.

These officials could not identify the degree to which each of these reasons contributed to improperly maintained filing requirements.

Conclusions

Unproductive nonfiler investigations occurred because businesses were issued more than one EIN and because businesses did not always follow IRS regulations and instructions that require them to file employment tax returns even though they have no tax liability. Also, IRS employees did not always accurately maintain the business' filing requirements on the master file. Inaccurately maintained filing requirements will likely cause IRS to initiate unproductive nonfiler investigations in the future or decrease the likelihood of IRS detecting potential business nonfilers.

IRS could reduce unproductive investigations by better controlling the issuance of EINS, emphasizing to businesses the importance of filing employment tax returns as required, modifying its computer programs for deleting employment tax return filing requirements, and assuring the filing requirements recorded on IRS' master file are accurate.

Recommendations

To reduce the number of unproductive nonfiler investigations, we recommend that the Commissioner of Internal Revenue

- adopt additional research techniques, such as using variations of the business name and the actual signature name on the return, and actively pursue the receipt of Forms SS-4 to identify businesses with previously issued EINS;

- revise employment tax return instructions and business nonfiler notices to emphasize to businesses the importance of filing required quarterly employment tax returns;
- modify criteria for deleting invalid employment tax return filing requirements to include the results of nonfiler investigations; and
- ensure that the filing status determined from nonfiler investigations is accurately recorded on business master file accounts.

Agency Comments and Our Evaluation

IRS agreed with our recommendations in an April 14, 1988, letter (see app.). IRS said it will implement our recommendation to identify businesses with previously issued EINS by (1) revising its procedures and training guide to require additional research before issuing an EIN and (2) initiating procedures to actively pursue receipt of Forms SS-4.

Regarding our recommendation to revise employment tax return instructions and nonfiler notices, IRS said it will attempt to highlight the message in its instructions on the importance of filing required quarterly employment tax returns, even when no taxes are owed. As for nonfiler notices, IRS said that it would determine how to highlight such information during its review of all taxpayer notices, which its expects to complete by July 1989.

To implement our recommendation on including the results of nonfiler investigations in its criteria for deleting invalid employment tax return filing requirements, IRS said that it will change its procedures and computer system codes to incorporate and use the results of nonfiler investigations in determining a business' filing requirements.

As for our recommendation on the accuracy of filing requirements recorded on the business master file, IRS said it will use the results from employment tax return nonfiler investigations to maintain the accuracy of the business master file. We support this action and encourage IRS to also accurately record the results from investigations of other types of returns, such as income and excise tax returns, on the business master file.

Comments From the Commissioner of Internal Revenue

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

COMMISSIONER

APR 14 1988

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: IRS Could Reduce the Number of Unproductive Business Nonfiler Investigations". We agree with the report's conclusions and recommendations. Detailed comments on the report recommendations are enclosed.

We hope you find these comments useful.

With kind regards,

Sincerely,

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX ADMINISTRATION: IRS COULD REDUCE THE NUMBER OF
UNPRODUCTIVE BUSINESS NONFILER INVESTIGATIONS"

Recommendation 1:

Adopt additional research techniques, such as using variations of the business name and the actual signature name of the return, and actively pursue the receipt of Forms SS-4 to identify businesses with previously-issued employer identification numbers.

Comment:

We agree that the program for assigning EINs should be improved. We also agree that both of the specific improvements you suggested in your report should be implemented and we will revise our IRM procedures and our training guide to require additional research when assigning an EIN. In addition, we will initiate new follow-up procedures to secure Forms SS-4, as proposed.

Recommendation 2:

Revise employment tax return instructions and business nonfiler notices to emphasize to businesses the importance of filing required quarterly employment tax returns.

Comment:

Employment tax returns already caution taxpayers to file required quarterly returns even if no tax is owing or to notify IRS that they are no longer required to file. We will attempt to highlight this message to emphasize its importance. We are currently reviewing all notices and letters for tone and content; we expect to complete all necessary revisions to the notices and letters by July 1989. During our review of the business nonfiler notices, we will determine how to highlight information concerning the importance of filing the required quarterly return even when no wages are paid.

Recommendation 3:

Modify criteria for deleting invalid employment tax return filing requirements to include the results of nonfiler investigations.

Comment:

We agree with the recommendation and will implement it by changing our procedures for noting that a taxpayer is not liable for filing a return based on information determined as a result of our investigation. We will also request a systemic change to accept a code based on this information. The request for data services will ask for a change in the program beginning in January 1989.

Recommendation 4:

Ensure that the filing status determined from nonfiling investigations are accurately recorded on business master file accounts.

Comment:

The information captured on the file noted above will also be used to update the accuracy of the Business Master File. This should improve the productivity of the employment tax return investigations by eliminating those who have already demonstrated to the IRS that they have no filing requirement.

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