United States General Accounting Office

GAO

Report to the Honorable
Doug Barnard, Jr., Chairman,
Subcommittee on Commerce, Consumer,
and Monetary Affairs, House Committee
on Government Operations

July 1988

TAX ADMINISTRATION

IRS' Efforts to Establish a Business Information Returns Program

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GAO

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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 May 6, 1987, request, and subsequent discussions with the Subcommittee, to provide status reports on the Internal Revenue Service's (IRS) plans, timeframes, and accomplishments concerning its evaluation and implementation of a document matching program for business taxpayers.

This program would match information returns, filed by third-party sources, for income such as interest and dividends, to tax returns that were filed by sole proprietors, partnerships, and corporations. This document matching program would be similar to the one IRS has for identifying individuals who underreport their income or fail to file tax returns. IRS considers its document matching program for individuals to be cost effective with a yield-to-cost ratio of 16 to 1 in 1987.

Background

The idea of developing a business document matching program is not new. In a 1981 study,[1] IRS concluded that this program would not be feasible because impediments existed in matching information returns to business tax returns. For example, a tax return usually covers a fiscal year while an information return usually covers a calendar year. IRS did not attempt to identify ways to overcome these impediments or to develop a business document matching program.

As a result of your March 17, 1987, hearing, IRS officials recognized that more could be done to implement a document matching program for business taxpayers, and developed an action plan that they submitted to you on September 1, 1987. IRS' action plan contains three initiatives, which are scheduled to be completed by December 31, 1990. IRS will (1) develop a program to match income reported on information returns with income sole proprietors reported on income tax returns, (2) evaluate the merits of using information returns to identify partnership and

[1] The Business Master File Information Returns Program Study Report, Internal Revenue Service, December 1981.

corporate nonfilers (those who should file but do not), and (3) determine the costs and benefits of a document matching program for corporations. This report discusses the progress IRS had made as of May 31, 1988, in meeting these action plan initiatives.

Results in Brief

IRS is proceeding on schedule to complete the action plan initiatives (see app. I for milestone dates). On the first initiative, IRS developed a cross-reference file that contains both the sole proprietor's social security number (SSN) and employer identification number (EIN). IRS plans to use this file to combine information returns submitted under the sole proprietors' EINs with those submitted under their SSNs for matching against the income reported on their tax returns. On the second initiative, IRS completed a pilot project in its Manhattan District Office which demonstrated that information returns are useful for detecting partnership and corporate nonfilers. On the third initiative, IRS developed methodologies for determining the costs and benefits of a corporate document matching program.

We have identified some areas where IRS could improve the implementation of its action plan. We suggested that IRS (1) expand its cross-reference file to include more data on sole proprietors, (2) evaluate information from all delinquent returns obtained through nonfiler investigations of partnerships and corporations, (3) verify taxpayers' statements made during nonfiler investigations, (4) include the proper mix of personnel costs in computing the costs of a document matching program for corporations, and (5) include just the additional tax revenue that would result from using information returns to identify unreported income in calculating the benefits of a corporate document matching program.

IRS has agreed with our suggestions and is either adopting them or further studying their merits before deciding what action to take. Appendix II has a detailed discussion of the three initiatives, the areas where IRS could improve the implementation of its plan, and the actions that IRS has agreed to take on our suggestions.

Objective, Scope, and Methodology

To monitor IRS' progress in developing a business document matching program, we

- reviewed IRS' action plan,
- interviewed IRS officials responsible for the plan's three initiatives,

- reviewed the forms and instructions IRS will use to gather the data needed to evaluate the initiatives,
- analyzed 84 business nonfiler investigations from IRS' pilot project in the Manhattan District Office on using information returns to identify partnership and corporate nonfilers, and
- reviewed IRS' approach to determine the costs and benefits of a corporate matching program.

We did our work from September 1987 through May 1988 at the IRS National Office in Washington, D.C., in accordance with generally accepted government auditing standards.

We discussed our results with the IRS officials responsible for the business document matching program's action plan initiatives and considered their comments in preparing this report. As agreed, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the issuance date. At that time, we will send copies to IRS, to interested congressional committees and to other interested parties.

We will continue to monitor IRS' progress in assessing the feasibility of a business document matching program and will keep the Subcommittee apprised of the status of IRS' action plan initiatives. If you have any questions about the information we obtained, please contact Gerald Stankosky of my staff on 272-7904.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Associate Director

Contents

Abbreviations

EIN	Employer Identification Number
GAO	General Accounting Office
IRS	Internal Revenue Service
SSN	Social Security Number

IRS' Business Information Returns Action Plan With Scheduled Completion Dates

Planned Action	Scheduled Completion Date[a]
I. Matching Sole Proprietors' Information Returns with Tax Returns	
A. Develop a cross-reference file	01-01-88
B. Test the cross-reference file	07-31-88
C. Use EINs for individual document matching	03-01-89
II. Using Information Returns to Identify Partnership and Corporate Nonfilers	
A. Select a sample of nonfilers and conduct field investigations	12-31-87
B. Evaluate results and determine costs and benefits of a full-scale program	12-31-88[b]
C. Implement full-scale program (if warranted)	04-30-89
III. Determining the Costs and Benefits of a Document Matching Program for Corporations	
A. Costs	
1. Estimate the number of information returns to be processed	06-30-88
2. Determine program costs for a corporate document matching program	12-31-88
B. Benefits	
1. Corporations with assets of $10 million and over	12-31-90
2. Corporations with assets under $10 million	12-31-90
C. Complete cost and benefit studies for final report	12-31-90

[a]Unless otherwise noted, the scheduled completion dates are the same as those originally reflected in IRS' action plan.

[b]The original scheduled completion date was April 30, 1988.

Background and Status of IRS' Action Plan Initiatives

Background

The idea of developing a business document matching program is not new. In a 1981 study, IRS concluded that this program would not be feasible because impediments existed in matching information returns to business tax returns. For example, a tax return usually covers a fiscal year while an information return usually covers a calendar year. IRS did not attempt to identify ways to overcome these impediments or to develop a business document matching program.

In May 1986, you asked us to review the feasibility of developing a business document matching program and to identify options for overcoming the impediments that IRS identified. We testified on the results of our work at your March 17, 1987, hearing.[1] We said IRS could begin using information returns to identify potential business nonfilers and some sole proprietors who potentially underreport income while also estimating the costs and benefits of a business document matching program for partnerships and corporations. Furthermore, we presented options for overcoming impediments that IRS identified in 1981.

We also pointed out that under current law, payers of income, such as banks, are not required to file information returns on payments made to corporations. Unless the law is changed, a document matching program covering corporations would be limited to those information returns voluntarily filed on corporations. This limitation could be eliminated with the passage of legislation that you introduced on May 4, 1988, requiring the filing of information returns for interest, dividend, royalty, and other income paid to corporations.

As a result of this hearing, IRS officials recognized that more could be done and developed an action plan which they submitted to the Subcommittee on September 1, 1987. IRS' action plan contains three initiatives, which are scheduled to be completed by December 31, 1990. IRS will (1) develop a program to match income reported on information returns with income sole proprietors reported on income tax returns, (2) evaluate the merits of using information returns to identify partnership and corporate nonfilers (those who should file but do not), and (3) determine the costs and benefits of a document matching program for corporations. This appendix discusses the progress IRS has made as of May 31, 1988, in meeting these action plan initiatives.

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

Initiative 1: Matching Sole Proprietors' Information Returns With Tax Returns

Sole proprietors report their business income on Schedule C, Profit or (Loss) From Business or Profession, and/or Schedule F, Farm Income and Expenses. The schedules are submitted along with Form 1040, U.S. Individual Income Tax Return. Sole proprietors may receive information returns from payers either under their employer identification number (EIN) or social security number (SSN). However, IRS uses only the information returns received under sole proprietors' SSNs to detect underreporters and nonfilers. As discussed in our 1987 testimony, IRS does this because it does not have a way to associate information returns received under sole proprietors' EINs with the taxpayers' Form 1040, which is filed under taxpayers' SSNs.

IRS met its January 1, 1988, action plan completion date for creating a cross-reference file that associates sole proprietors' EINs with their SSNs. The file was created from EINs reported on Schedules C and F for tax year 1986. This file will enable IRS to consolidate information return data received under sole proprietors' EINs with those received under their SSNs. By matching this consolidated data against income tax returns, IRS will be better able to determine whether sole proprietors filed their tax returns and reported all the income shown on the information returns. IRS expects to begin including information returns submitted under EINs in its Individual Information Returns Program by March 1, 1989.

IRS' Examination Division is testing the accuracy of the EINs and SSNs on the cross-reference file. The test consists of sampling 350 tax returns from tax year 1986—50 returns from each of the seven district offices served by the Austin Service Center. To test the file's accuracy and ensure that the EINs were transcribed correctly, IRS will compare the EINs on the Schedules C or F as well as the SSNs on the Forms 1040 to those on the cross-reference file. This test is scheduled to be completed by July 31, 1988.

The cross-reference file only includes sole proprietors who file a Schedule C or F under an EIN. The file does not include other sole proprietors who either do not submit a Schedule C or F or submit these schedules under their SSNs instead of their EINs. Consequently, the file will not help IRS to detect these sole proprietors when they underreport their income. However, IRS' Collection Division does have data on some of these sole proprietors that could be included in the cross-reference file.

Since July 1987, the Collection Division has been entering onto the Business Master File both the taxpayers' EINs and SSNs shown on the Forms

SS-4 (Application for Employer Identification Number). This project, among other things, allows Collection personnel to have SSNs to more readily locate and contact sole proprietors who fail to pay employment taxes. For example, the SSN allows IRS to get the home address from the sole proprietor's individual income tax return.

The Collection Division's project is not part of the action plan; therefore, the EINs and SSNs being entered onto the business master file accounts are not being entered onto the Examination Division's cross-reference file. If IRS included Collection's data on Examination's cross-reference file, IRS would then be able to identify sole proprietors who receive income reported on information returns under their EIN even if they do not file a Schedule C or F. IRS officials said our suggestion has merit but that they could not readily update the cross-reference file with Collection's data until they study further how the data could be combined.

Initiative 2: Using Information Returns to Identify Partnership and Corporate Nonfilers

IRS' current program to identify partnership and corporate nonfilers does not use information returns and does not obtain as high a percentage of delinquent tax returns as the document matching program used to identify individual nonfilers. The current business nonfiler program only identifies potential nonfilers when businesses file tax returns one year but not the next year. This approach results in IRS getting tax returns from about 27 percent of the businesses it investigates. In contrast, the individual document matching program uses IRS information returns filed by third-party payers to identify potential individual nonfilers in addition to checking whether a prior year tax return was filed. By so doing, IRS gets tax returns from about 41 percent of the individuals it investigates.

Under the action plan, IRS' Collection Division is testing, in two phases, whether information returns can be used to identify partnership and corporate nonfilers. The first phase, completed on schedule on December 31, 1987, tested a methodology for selecting potential business nonfiler cases in one district office. In phase two, IRS will investigate cases selected in nine district offices.

Phase one identified a universe of 446 potential business nonfilers by matching their EINs on calendar year 1985 information returns with the businesses' master file accounts. The match showed that the businesses had not filed income tax returns for tax year 1985. The 446 cases consisted of partnerships, corporations, and estates from three zip code areas in IRS' Manhattan District Office. The Brookhaven Service Center screened out 362 of the 446 cases because they involved (1) businesses already being investigated by IRS, (2) subsidiary corporations that filed with a parent corporation, (3) estates where the information return amounts were less than the $600 required for the estate to file a return, or (4) estates that were being administered by the City of New York and that IRS did not believe were necessary to investigate.

Based on its preliminary test results, IRS revised and refined its criteria for selecting the potential nonfiler cases to be investigated in phase two. The revised criteria should eliminate most of the types of cases that were screened out in phase one. IRS will use the revised criteria to randomly select about 2,000 potential nonfilers for investigation during phase two in nine district offices: Atlanta, Chicago, Des Moines, St. Louis, Jacksonville, Cincinnati, Cleveland, San Francisco, and Los Angeles.

Phase two, which was scheduled to be completed by April 30, 1988, has been delayed due to the need for the changes in the selection criteria and in the computer programs used to select the 2,000 cases. IRS now expects to begin phase two investigations in June and to complete them by December 31, 1988. IRS officials said that, if warranted, they plan to implement a full-scale partnership and corporate nonfiler program by April 30, 1989.

Our analysis of the 84 cases that were investigated in the Manhattan District pilot test (446 minus the 362 that were screened out) showed that information returns were useful to identify business nonfilers. IRS got 42 additional returns from 25, or 30 percent, of the 84 taxpayers investigated. However, the checksheets that Collection Division revenue officers used to record the results of their investigations did not show all results. For example, the checksheets only had data on one income tax return per investigated case. Of the 25 cases where delinquent returns were obtained, we found that more than one delinquent return was obtained in 14 cases. Our analysis also showed that complete investigations were not made for all the cases. We found that the revenue officers closed 10 of the 84 cases because the taxpayers said they had previously filed the returns, but our analysis of IRS' business master file accounts for these 10 cases showed that in 2 cases the returns were not filed until after the initiation of IRS' investigation. Furthermore, in 5 of these cases, the returns had not been filed when we completed our analysis in March 1988.

To completely evaluate the usefulness of information returns, IRS needs data from all of the returns obtained during the investigations. To ensure a complete and accurate evaluation of phase two sample cases, we believe that IRS should verify taxpayers' statements before compiling the test results. IRS agreed to make these changes.

Initiative 3: Determining Costs and Benefits of a Document Matching Program for Corporations

IRS is doing one study to determine the potential costs and two studies—corporations with assets of $10 million and over and corporations with assets under $10 million—to determine the potential benefits of a corporate document matching program. As with any proposed program, there are many different variables which could be considered in doing a cost-benefit study. We did not attempt to assess whether IRS considered all possible variables in its cost and benefit studies. However, from our understanding of IRS' individual document matching program and our work on the feasibility of a business document matching program, we believe that IRS' studies are considering the primary factors for a corporate document matching program. These factors include the volume of corporate information returns to be processed and the IRS resources needed to match them against corporate tax returns.

Regarding the cost study, IRS developed assumptions for estimating the costs of a corporate document matching program. These assumptions follow:

- Legislative and regulatory changes will be made to require information return reporting on payments made to corporations.
- Corporations will be required to complete a reconciliation schedule so that information returns filed on a calendar year basis can be matched to tax returns filed on a fiscal year basis, and so that information returns for corporations that use a cash or accrual method of accounting can be matched to their tax returns.
- Corporate returns will contain a schedule for itemizing sources of interest and dividend income similar to Schedule B, Interest and Dividend Income, of Form 1040.
- The IRS matching program will include only corporations that file Forms 1120 and 1120A (i.e., income tax returns for U.S. corporations).
- Cost estimates will be done for five types of income—capital gains, dividends, interest, rents, and royalties—that have separate lines for reporting on Forms 1120/1120A.
- Revenue agents will be used at service centers to screen the potential underreporter cases, correspond with the taxpayers, and resolve cases where taxpayers disagree with IRS' underreporter determinations.

For the most part, our analysis showed that IRS' assumptions are reasonable. However, the estimates will not include any costs that taxpayers may incur from complying with the additional filing requirements (e.g., reconciliation schedules).

We do not believe that IRS should assume that only revenue agents have to be used to determine whether corporations reported all information return income. A corporate document matching program should work like IRS' individual document matching program. A computer match will be made of the income reported on the tax return with the income on the information returns. If information return amounts exceed tax return amounts, service center tax examiners will do manual reviews to determine if the income was reported elsewhere on the tax return or was not required to be reported. Under IRS' corporate document matching program, the manual review will include the reconciliation schedules that corporations will submit with their tax returns as well as schedules that list interest and dividend sources. On the basis of our analysis of corporate tax returns for our March 1987 testimony, this manual review would not require the high level auditing skills of revenue agents.

We suggested to IRS officials responsible for the cost study that they also develop personnel costs from using lower paid tax examiners who screen individual underreporter cases. According to IRS officials, these tax examiners are paid an average of $7.25 an hour whereas the average hourly rate of revenue agents is $11.50. IRS officials believed that the complexities of corporate tax returns will require revenue agents to screen potential corporate underreporter cases. Nonetheless, they said that they would consider developing two cost estimates—one using revenue agents and the other using revenue agents and tax examiners. They said that before they change their cost assumptions they need more data on the types of corporate underreporter cases that may emerge.

Before IRS can complete its cost estimates, it must estimate the number of information returns it would receive on payments made to corporations. IRS officials expect to complete this estimate by June 30, 1988. They expect the total program costs, including equipment, labor, and overhead costs for processing information returns to be estimated by December 31, 1988.

With regard to the two benefits studies, IRS' study of corporations with assets of $10 million and over will cover about 1,500 corporations that IRS planned to select for examination by June 30, 1988, and cover returns with a tax year ending between June 30, 1984, and December 31, 1986. These returns are not being specifically selected for this study. IRS had planned to examine them as part of its ongoing corporate examination program. IRS plans to complete these examinations by September 30, 1990.

IRS' study for corporations with assets of less than $10 million will include about 13,600 corporate returns that have been processed in 1988. As with the other benefits study, IRS is not selecting these returns just for this study. Rather, IRS will examine these returns under its periodic Taxpayer Compliance Measurement Program. These examinations are expected to begin on September 1, 1988, and to be completed by May 31, 1990.

Revenue agents doing these two studies will fill out checksheets to collect the data IRS deems necessary to determine the benefits of a corporate document matching program. Both checksheets will show whether the corporations reported the income on the information returns that IRS has collected on the corporations, along with the reasons for any underreporting of the income.

Our analysis of the two checksheets showed that IRS could improve its methodology for calculating these benefits. Program benefits should be limited to the additional taxes that result from the unreported income identified by using the information returns. We found that IRS' checksheets would include other tax adjustments that would not be found in a document matching program, like erroneous deductions from income.

These types of adjustments generally cannot be identified without doing a full scale examination of taxpayers' books and records, which a document matching program would not include. Instead, the program would match the amount of income on the tax return with the amount on the information returns. IRS would propose tax assessments when the information return income exceeds the income on the tax return.

We suggested to IRS officials that they modify the checksheets so that the benefit calculation would include just the additional tax associated with the unreported income that IRS identified by using information returns. IRS officials agreed with our observation. However, they said that checksheets and instructions for the study of the 1,500 returns with assets of $10 million and over have already been printed and distributed to the field offices. They said that to modify the checksheets would jeopardize the timely completion of related examinations. IRS will be able to approximate the benefits of the corporate document matching program without modifying the checksheets. However, to avoid overstating the benefits, IRS will need to refine the data to identify just the specific amount of additional taxes due as a result of using information returns.

In regard to the study of corporations with assets of less than $10 million, IRS officials said that the checksheets and instructions for this study are being printed. They said that to delay the printing would delay the September 1, 1988, start date for the Taxpayer Compliance Measurement Program examinations. They said that because much more return information is being entered on the checksheets for these examinations than for the 1,500 returns with assets of $10 million and over, they can develop a computer program to make more specific benefit calculations on these returns.

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