

GAO

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

September 1991

TAX ADMINISTRATION

Benefits of a Corporate Document Matching Program Exceed the Costs



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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 analyze several issues that arose following our June 10, 1991, testimony before your Subcommittee on the feasibility of an Internal Revenue Service (IRS) document matching program for payments to corporations. These issues involve what legislative actions Congress needs to take and how IRS can reduce the program's burden on the business community. Our analysis of the issues is in appendix I. To provide the proper context for our analysis, we have included a copy of our testimony in appendix II.

IRS' document matching program for payments to individuals has proven to be a highly cost-effective way of bringing in billions of dollars in tax revenues to the Treasury while at the same time boosting voluntary compliance. However, unlike payments to individuals, the law does not require that information returns be submitted on most payments to corporations. We believe that similar results would occur if the law required information returns that reported payments to corporations and if IRS developed a program to match these documents to corporate tax returns.

In our testimony, we stated that the benefits to the federal government from a corporate document matching program exceed the costs. This report provides our analysis of the steps needed to make the program a reality. First, Congress needs to pass legislation that would require payments to corporations to be reported on information returns and to appropriate the necessary funds for IRS to implement the program. Because such a reporting requirement can create burdens on the business community, it is important for IRS to take steps to ease these burdens and facilitate the reporting and matching of payments. For example, IRS could phase in the reporting requirement and document match over several years and slowly expand the program as both IRS and the business community learn from their initial experiences.

Appendix I provides more details on these options, along with our analysis of other issues raised in your letter. Responsible officials at IRS provided comments on a draft of this report. They generally agreed with our analysis. Their comments were incorporated where appropriate.

Objectives, Scope, and Methodology

Our objective was to determine what actions IRS and Congress need to take to implement a corporate document matching program with the least burden on the business community. To do this, we analyzed (1) the testimony given by representatives of the business community before your Subcommittee on July 24, 1991, and (2) the Internal Revenue Code sections on information reporting.

We did our work in Washington, D.C., during July and August 1991 in accordance with generally accepted government auditing standards.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from the date of issuance. At that time, we will send copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

This report was prepared under the direction of Paul L. Posner, Associate Director, Tax Policy and Administration Issues, who can be reached at (202) 272-7904 if you or your staff have any questions or comments. Other major contributors to this report are listed in appendix III.

Sincerely yours,



Richard L. Fogel
Assistant Comptroller General

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Abbreviations

| | |
|------|---|
| IRS | Internal Revenue Service |
| TCMP | Taxpayer Compliance Measurement Program |

GAO Analysis of Several Issues Regarding Corporate Document Matching Program

Issue 1: Given the possible barriers and burdens on the business community of corporate matching, what could IRS do now to establish a corporate matching program and make it work with the least burden?

To reduce the burden on the business community, Congress and IRS could phase in the program over several years. Such an approach would recognize the valid concerns about burden and technical issues discussed in our testimony (see app. II).

We have identified and analyzed three phase-in options: (1) require only a portion of payors to report their payments to corporations, (2) require all payors to report their payments only to certain corporations, or (3) require all payors to report only certain types of payments. There may be other options that IRS should consider. While all the options would reduce the burden on the payor community, option 3 would seem to do the most to promote voluntary compliance among all corporations and present IRS with the fewest barriers to an effective document match.

Option 1—requiring only a portion of payors to report—would obviously reduce the burden on those payors not selected. However, not having information returns on all payments to corporations would do little to promote voluntary compliance. For example, a particular corporation may have received a total of \$1 million in interest during the year but only \$200,000 of it was reported to IRS from the selected payors. Without all of the payors reporting, the corporation might in turn report on its tax return only the \$200,000, and the document matching program would not be able to detect the \$800,000 that was underreported. This limitation would greatly reduce the match's effectiveness.

Option 2—requiring all payors to report all of their payments only to corporations in certain designated categories—would reduce the volume of information returns that payors must issue but would do nothing to promote compliance among those corporations not selected. Potential designated categories could be those corporations of a particular size, industry, or geographic location.

Under this option, either IRS could notify payors of the selected corporations or the corporations could self-certify to their payors whether they met the IRS criteria. Both methods have disadvantages. With the frequency of corporate mergers, acquisitions, and new businesses, it would be time consuming for IRS to provide all payors with a current list and

time consuming for the payors to process the data. Similarly, if corporations were required to self-certify to their payors, those in the selected category that do not want their income to be reported to IRS may choose not to make the required certification, which IRS may not detect.

We believe that option 3—requiring all payors to report only certain types of income—is the preferred approach. This option avoids the problems discussed in the first two options and closely parallels the document matching program that IRS studied in its June 1991 report to Congress.¹ For example, Congress could start with interest, rents, and dividends paid to corporations and authorize IRS to add other types of payments later when both IRS and the payor community would have gained more experience with the program.

Payor burden under option 3 could be further reduced by delaying the reporting requirement for a few years. This would allow payors time to better plan how to minimize their costs when adapting their information systems to meet the new requirement. It would also allow IRS time to further develop its ongoing computer modernization effort to better meet the requirements of a corporate document matching program.

Issue 2: Specifically, what does Congress need to do to the existing laws in order to establish a corporate matching program?

First, Congress needs to pass legislation that would authorize IRS to require payors to report payments to corporations. Second, Congress needs to appropriate funds to cover IRS' additional costs. IRS currently estimates that annual operating costs for a document match of five types of income would be about \$70 million. Also, given IRS' reluctance to implement such a program, Congress should earmark such appropriations specifically for the corporate information returns program.

Issue 3: Are there any alternative approaches that could be employed to test this program?

We do not believe that additional testing of the program's basic feasibility is necessary to justify Congress enacting legislation to authorize the reporting of payments to corporations. Our testimony showed clearly how a corporate document matching program could produce \$1 billion in taxes annually by 1995 at an annual operating cost to IRS of about \$70 million. However, IRS could begin working with the payor

¹Internal Revenue Service Business Information Returns Study (June 1991).

community to test the best ways to resolve several technical issues discussed in our testimony (see app. II). For example, IRS needs to work with payors to determine the most efficient method of resolving problems that will occur during the match because payors file information returns on a calendar year basis while about 60 percent of corporations file tax returns on a fiscal year basis. For a proper match to take place, the data on both the information returns and the tax returns must correspond. Because payors and corporations have different reporting periods, the documents don't match and are flagged as problems. Some discussions should focus on the least burdensome options for resolving this issue. Several options have been suggested: (1) require that payors' annual information returns show payments made for each month of the calendar year, (2) require that payors' information returns show payments made during each payee's particular fiscal year, or (3) require taxpayers to reconcile the figures on their tax returns. IRS' tests of these options should identify their advantages and disadvantages.

Another way to test this program would be for both IRS and the payors to identify payments to corporations that could be excluded from the match. For example, IRS may want to exclude from the match those payments to corporations that act as nominees for other taxpayers since the corporations are not generally responsible for paying the taxes.

In addition, IRS could test the efficiency and effectiveness of the document match by initially limiting it to the most noncompliant sector—small corporations—and phasing in larger corporations later. This would reduce IRS' costs and target the program at the area with the greatest potential benefit. (IRS should still use the other information returns during large corporation audits to identify unreported income.)

Issue 4: Commissioner Goldberg indicated in his remarks that it may cost 4 million corporate taxpayers \$250 each to complete the reconciliation notices necessary for business matching. What does GAO think about this assessment?

Although the Commissioner did refer in his remarks to 4 million corporations' potential costs, we found that (1) IRS' study of a corporate matching program covered 2.6 million corporations and (2) IRS has no data or studies to support its estimate of the reconciliation cost to corporations. Moreover, about 40 percent of corporations would not have to file reconciliation schedules because they file tax returns on a calendar year basis. IRS could eliminate the need for corporations to prepare a reconciliation schedule, depending on the option selected, to resolve the

calendar year versus fiscal year problem discussed under issue 3. For example, if IRS decides to require that payors' annual information returns show payments made for each month of the calendar year, corporations that file by fiscal year would not need to complete a reconciliation schedule.

If corporations do incur some costs in preparing a reconciliation schedule, these costs may be offset by the benefits of having the information returns to help them identify and properly report their income. Proper reporting would allow corporations to avoid IRS-imposed interest and penalties on unpaid taxes following an audit. In March 1991 testimony on information returns' value in helping to identify individuals who underreport income or do not file tax returns, Commissioner Goldberg pointed to the benefits of proper information reporting. In sum, he said that accurate and timely information reporting can help taxpayers to voluntarily comply while incurring less of a financial burden.

Issue 5: In your testimony, you said that your review of 300 IRS audits showed that IRS' estimate of program benefits did not include about \$133,000 of potentially unreported income. Can you develop some estimate of how much unreported income that IRS' audits missed for the universe of small corporations, and if so, what is that estimated amount?

We believe that IRS' estimate of \$2.2 billion significantly understated the amount of unreported income that could be detected in a corporate document matching program. IRS developed its estimate using five types of unreported income—interest, dividends, rents, royalties, and capital gains—identified in its Taxpayer Compliance Measurement Program (TCMP) audits of 12,000 small corporations. Our review of 303 randomly selected returns, from about 8,000 for which the revenue agent had an information return, showed that about 15 percent of these audits contained errors. These errors understated the unreported income by \$133,000, or about 27 percent of the \$486,000 that IRS identified in our sample returns.

We have no data that would suggest that those corporations not included in our sample population have different compliance levels than those in our sample. However, since our sample population includes only 8,000 of the 12,000 corporations used in IRS' study, we cannot make statistically valid estimates to the universe of small corporations.

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IRS Needs To Implement A Corporate
Document Matching Program

Statement of
Richard L. Fogel, Assistant Comptroller General
General Government Division

Before the
Subcommittee on Commerce, Consumer and Monetary
Affairs
House of Representatives



GAO/T-GGD-91-40

GAO Form 160 (12/87)

IRS NEEDS TO IMPLEMENT A CORPORATE
DOCUMENT MATCHING PROGRAM

SUMMARY OF STATEMENT BY
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The latest Internal Revenue Service (IRS) data show that corporate compliance with the tax laws has declined to an alarming degree. In 1980, small corporations that IRS studied (about 80 percent of all corporations) voluntarily reported 81 percent of the taxes owed. Seven years later, in 1987, these corporations voluntarily reported only 61 percent--a 25-percent decrease from 1980. Currently, the only way IRS can detect this noncompliance is by auditing corporate tax returns. But the audit coverage has also declined. In 1990, IRS audited about 2.6 percent of all corporations, which is substantially less than the 6.5 percent corporate audit coverage it had in 1980. Further, audits are costly and IRS research studies have shown that without information returns, an audit will detect only about one-third of the income that taxpayers fail to report. However, unlike individuals, the law does not require that information returns be submitted on income earned by corporations.

Matching information returns to individual tax returns has proven to be a highly cost-effective way of bringing in billions of dollars in tax revenues to the Treasury while at the same time boosting voluntary compliance by individuals. GAO believes that similar results would occur if the law required information returns reporting on income earned by corporations and if IRS developed a program to match these documents to corporate tax returns. Recognizing start-up costs of \$70 million plus annual operating costs of \$70 million, GAO estimates that a limited corporate document matching program involving interest, dividends, rents, royalties, and capital gains would generate about \$1 billion in additional revenue. An expanded program that included more types of unreported corporate income could generate even more revenue. Given IRS' experience with the growth of the individual document matching program, the ratio of revenues to costs should only improve.

GAO recognizes that both corporate taxpayers as well as payors submitting information returns will experience some additional burden and may have to make changes to their accounting records and other information systems. A key to obtaining the cooperation and the compliance of these two groups is to see that they have adequate lead time to make an orderly conversion from their existing systems.

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to assist this Subcommittee in its continuing inquiry into the feasibility of instituting a document matching program for investment-type income earned by corporations. Today, I will address the Internal Revenue Service's (IRS) estimate of the benefits and costs of such a program, administrative issues that must be resolved, and potential burdens on businesses that file information returns.

We have appeared before this Subcommittee several times over the past 11 years to discuss the need for a business information returns program. Each time, we have shown the value of such a program for improving corporate compliance, just as it has done so well for individual taxpayers. Each time, IRS has expressed reservations about the costs and feasibility of the program. Now, thanks to your mandate, IRS has developed data that we believe conclusively demonstrate that the estimated benefits of a limited business information returns program would be much greater than the costs--annually generating about \$1 billion in revenue at a cost of less than \$70 million.

Some costs to submit information returns to IRS would have to be borne by payors, such as banks and brokerage firms, and certain administrative challenges will have to be overcome to properly match the income reported. Yet, on balance, we believe that now

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is the time for Congress and IRS to act. Growing budget deficits, increasing corporate noncompliance, and declining audit coverage all point to the need for a corporate document matching program similar to the one that has so effectively promoted voluntary compliance and full income reporting for the vast majority of wage earners.

INFORMATION RETURNS IMPROVE

COMPLIANCE

Payors of income, such as interest and dividends, have been required for many years to submit information returns on income paid to individuals. IRS then matches these documents against those individuals' tax returns to identify people who have understated their income or failed to file a return. IRS credits this document matching with billions of dollars in additional tax assessments. But the greatest revenue yields arise from improving voluntary compliance. IRS studies have shown that individuals report a higher percentage of income when they know IRS has data on their income. This information returns program, in concert with wage withholding, has prompted exceptionally high levels of compliance among wage earners in this country--99.6 percent of wages are accurately reported.

Because reporting is not required on payments made to corporations, IRS must rely on its examination program to assure

that corporations report all their income. However, as IRS' own research studies have shown, unreported income is difficult to detect without information returns submitted by third parties. Lacking these returns, the IRS revenue agent has little direct evidence about how much income the taxpayer failed to report. Even for the most comprehensive audits--those done under the Taxpayer Compliance Measurement Program (TCMP)--IRS acknowledges that it can find only about one-third of the unreported income without information returns. Moreover, IRS' corporate examination coverage is low--in 1990 IRS examined only 2.6 percent of corporations, down from 6.5 percent in 1980.

SMALL CORPORATE COMPLIANCE IS DECREASING

IRS' latest data on corporate income tax compliance suggest that now is the time for Congress to require information returns reporting on certain income earned by corporations. IRS' study data show that income tax compliance among 2.3 million small corporations--those with assets of less than \$10 million--has declined alarmingly, as shown in Chart 1.

These small corporations, comprising 80 percent of the Nation's corporations, voluntarily reported only 61 percent of the taxes they owed for tax year 1987--the most recent year for which information is available. This is a 25-percent drop in compliance from tax year 1980, when small corporations reported

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81 percent of the taxes they owed, according to IRS audit results. IRS found that small corporations underreported income by \$15.4 billion for 1987, compared to \$5 billion for 1980. This decline in compliance was also dramatic for the five types of income in IRS' study on business information returns. For example, capital gains income had the greatest drop in the voluntary reporting of income--from 96 percent to 84 percent--which led to unreported income increasing from \$138 million in 1980 to \$1.1 billion in 1987.

Another category of businesses consists of S corporations and partnerships. The 1.1 million S corporations and the 1.6 million partnerships reported income of \$1.4 trillion in 1987. IRS has no current compliance data for these businesses. However, IRS found that partnerships underreported about \$5 billion for 1981, and S corporations underreported over \$2 billion for 1985. While these data are old, IRS has no evidence that compliance has improved, particularly when it has declined for small corporations.

Moreover, IRS unfortunately does not do comprehensive assessments of tax noncompliance by larger corporations. For corporations exceeding \$10 million in assets--which receive 85 percent of all corporate income--the agency can only measure noncompliance by additional taxes that its agents recommend from their normal audits. These audits cover only a small portion of these larger

corporate taxpayers and typically focus on only a selected number of issues. Thus, neither IRS nor we know the trends in the amounts or rates of noncompliance among these larger corporations. We do know that in fiscal year 1990 these corporations paid about \$100 billion in income taxes, and IRS recommended about \$14 billion in additional taxes.

A DOCUMENT MATCHING PROGRAM

WOULD BE COST EFFECTIVE

We believe that a business document matching program would be a cost-effective way to improve business compliance. IRS' June 1991 report shows that such a program could generate from \$485 million to \$636 million in benefits in 1995--the first full year of operation--at a cost of \$83 million.¹

IRS audited a random sample of about 12,000 small corporations with assets of less than \$10 million and a nonrandom sample of 618 returns for corporations with assets over \$10 million.²

Revenue agents determined whether five types of income--interest,

¹In its study, IRS estimates benefits and costs for tax year 1989 and 1992, respectively. To make our estimates comparable, we have adjusted IRS' estimates of costs and benefits to 1995.

²This group excludes 1,500 large corporations who have assets over \$100 million and are part of IRS' Coordinated Examination Program. According to IRS officials, these corporations will not be in a document matching program because IRS audits them on a continuous basis. However, IRS will use information returns when auditing them to determine whether the income was reported.

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dividends, rents, royalties, and capital gains--were reported on the tax return and determined reasons why any income was not reported. We reviewed a random sample of 300 cases for small corporations and 60 cases for the large corporations to ascertain the validity of IRS' assumptions and results.

In our view, IRS' estimate represents the tip of the proverbial iceberg. We found that the benefits of a fully functioning business information returns program would go far beyond those stated in the IRS study.

For small corporations alone, we found that IRS' study underestimates the benefits. Most importantly, IRS does not capture any benefits that would be generated by assigning revenue agents to pursue technical issues raised by the match. Although IRS assumes that 328 revenue agents would be needed, it included no benefits that would be derived from resolving technical issues. Using IRS' data on the average yield produced by agents doing such work, we added \$294 million to reflect benefits that these agents would identify when resolving issues generated by the match, such as basis adjustments, or the expenses claimed against rental income. In addition, IRS omitted \$75 million for interest that it would obtain on tax deficiencies identified through the matching program. Adding these two elements, along with several other adjustments, results in benefits ranging from \$830 million to \$1.1 billion for just the

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five types of income for small corporations in 1995, as shown on Chart 2. A detailed presentation of our estimates and assumptions for this segment of business income can be found in appendix I.

However, even our estimates capture only a fraction of the ultimate benefits that could be expected from a full business information returns program. Specifically:

-- The five types of income in IRS' study comprise only 10 percent of total income for corporations of all sizes, as shown in Chart 3. For just small corporations, these five types comprise only \$2.2 billion of the \$15.4 billion in unreported income. We would expect a full business information returns program to capture more than the five types of unreported income, such as payments made for services. For example, while starting with only wages, interest and dividends, the individual information returns program now captures over 30 types of income.

-- The study did not estimate benefits for three important types of business--the 1.1 million S corporations, the 1.6 million partnerships, and the 1,500 largest corporations in the Coordinated Examination Program. As chart 4 shows, these businesses account for about half of the returns that businesses file. As I noted earlier, previous IRS studies

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found \$7 billion in unreported income for partnerships and S corporations. It is reasonable to expect that information reporting for payments to these businesses could capture at least some of this unreported income. For example, IRS estimated that matching information returns to tax returns on service payments made to sole proprietorships--similar in many respects to partnerships and S corporations --could have identified enough unreported income for 1987 to generate up to \$210 million in additional taxes.

- The amount of unreported income shown in IRS' study is understated. IRS developed its estimate using unreported income identified in its TCMP audits. We reviewed 300 of the 8,000 audits where the revenue agent had an information return, and found that almost 15 percent of the cases contained errors which understated the unreported income. For our sample cases, IRS identified \$486,000 in unreported income, and we found an additional \$133,000 (27 percent) of unreported income which was not included in IRS' estimate. While our sample was not statistically projectable to all 2.3 million small corporations, such an error rate suggests that IRS' may have greatly underestimated the amount of unreported income.

- The estimate does not include benefits for the additional revenues that would result from revenue agents having access

to information returns during audits. IRS studies show that agents will find 3 times more unreported income during individual audits if they have access to information returns. IRS has used a similar "multiplier" to compute the tax gap from unreported income by small corporations.

-- The estimate does not include potential benefits that may result from improved reporting by payors. For example, in the most recent TCMP audits, IRS found \$1.3 billion in overstated interest and rent expenses claimed by small corporations. We believe that these corporations would be less likely to overstate their expense deductions if they had to provide information returns on these expenses.

Many of these latter benefits are not now quantifiable due to the limited scope of IRS' study. Nonetheless, for a business information returns program covering all types of businesses and most types of income, we believe it is not unreasonable to expect the program to generate well over \$1 billion in additional tax revenue annually.

The benefits of even a narrowly conceived program contemplated in IRS' study far outweigh the costs to IRS. We estimate that operating costs for this program will be about \$70 million in 1995 to process 165 million information returns, operate the computers that match information returns against tax returns, and

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hire additional staff to work cases in which unreported income is identified.

Although our cost estimate is \$13 million lower than IRS' estimate, we do not disagree over the program's major cost components. Nearly all the difference comes from IRS spreading the program's \$70 million start up costs over 5 years and we included them in our first year cost estimate.

All the cost and benefit estimates show the program is cost effective. We calculate 1995 benefit to cost ratios ranging from \$12 : \$1 to \$16 : \$1. While an excess of benefits over costs may not be the only consideration when deciding whether to implement this program, it is most certainly an important one.

ADMINISTRATIVE ISSUES NEED TO BE RESOLVED TO IMPLEMENT AN
EFFECTIVE DOCUMENT MATCHING PROGRAM

Before a document matching program can be implemented, the law has to be changed to require filing of information returns on payments made to corporations. Also, several administrative issues have to be resolved to make the program more successful and to avoid generating false underreporter cases. In appendix II, we discuss these issues and the solutions to these issues that IRS used in its program costing assumptions. For now, let me go over the most commonly cited issues.

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First, information returns are reported on a calendar year basis, while about 60 percent of the corporations file tax returns on a fiscal year basis. IRS found that about 40 percent of the income shown on information returns was not shown on tax returns due to differences in reporting periods, not underreported income. For costing purposes, IRS' proposed solution to this matching problem was to require that annual information returns break down the income earned by month to permit IRS to reconcile income across differing tax periods. Another option would be to require corporations to reconcile fiscal year income with calendar year based information return income on the filed tax return. The first option places a relatively greater burden on the payor company issuing the information return, while the second option shifts the burden toward the taxpaying corporation.

Another administrative issue thought to complicate a business matching program stems from differences in accounting for income. Information returns report payments using the cash method of accounting, while almost 54 percent of the corporations report income using the accrual accounting method. This difference can generate "false" underreporting leads. For example, a bank reported all interest payments to a corporation from an 18-month certificate of deposit on a cash basis, which accounts for the income when the certificate matured. The corporation correctly reported earning the interest income on an accrual basis, which

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accounts for the income before the 18 months expired. A document match would falsely indicate underreporting due to the payor and the corporation accounting for the same income in different years. However, IRS' study showed that this problem affected only about 1 percent of the income that appeared on information returns but not on tax returns.

In its costing assumptions, IRS proposed that taxpayers be required to use the cash basis for income subject to matching. We disagree. Accrual reporting more properly recognizes income when it is earned, and for this reason the Tax Reform Act of 1986 required all but the smallest corporations to report taxes on this basis. Given the small incidence of this kind of mismatch, we believe that IRS can adequately resolve any problems by working with taxpayers rather than by changing corporate accounting methods.

We believe that these and the other administrative issues can be resolved by IRS working cooperatively with the payor and business communities.

CONCERNS ABOUT TAXPAYER AND PAYOR COSTS

We recognize that corporate taxpayers as well as payors submitting information returns will experience some additional burden and may have to change accounting records and other

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information systems. A key to obtaining the cooperation and the compliance of these two groups is to allow adequate lead time for making an orderly conversion from their existing systems. This conversion could be complex, just as it was in the early days of the individual document matching program. According to IRS, the individual program needed over a decade and considerable technical activity to resolve the major problems facing the payor community. For example, information returns had to be modified and regulations issued on how to report income. Accordingly, IRS should consult with these groups in determining how much time to allow for converting systems to comply with new provisions.

A concern raised by representatives of major payor groups is the cost of providing IRS with the information needed to support a corporate document matching program. Clearly, requiring that payors provide additional information returns will result in some added costs to payors. However, on the basis of the limited cost data provided by some payors, these costs do not appear excessive.

For example, the Securities Industry Association estimates that first-year costs of issuing additional information returns for the entire industry will range from \$30 million to \$36 million, and recurring annual costs after the first year will be about \$7 million. Similarly, one official from a large corporation estimated that the corporation's costs for the individual program

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averaged \$.35 a return, or about \$65,000 annually. We were not able to evaluate any of the above cost estimates for reasonableness. However, it should be noted that many payors currently voluntarily submit information returns on payments to corporations because it is less costly than separating the two groups.

Payors we contacted also expressed concerns about the requirements for assuring the accuracy of the taxpayer identification number and the associated penalties when IRS records show an invalid identification number. In fact, this is an area where we have made several recommendations to IRS to help payors resolve incorrect information returns for the individual document matching program.³ We believe these recommendations could serve as the basis for IRS working with the payors to resolve these concerns in the business document matching program.

The experience of IRS and the payor community in adapting to the information returns program for individual taxpayers is instructive. At the inception of this program many similar concerns were raised. In April 1976 hearings before this Subcommittee, the IRS Commissioner indicated that IRS' initial efforts in the 1960s to match information returns against

³See Tax Administration: Accuracy of Taxpayer Identification Numbers on Information Returns Improved (GAO/GGD 88-110, September 6, 1988), and Information Returns: Correcting Taxpayer Identification Numbers is Possible Without Disclosing Tax Data (GAO/GGD 90-90, June 5, 1990).

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individual tax returns were not fruitful. He said that IRS was forced to conclude that (1) the cost of perfecting and processing information returns was exorbitant, (2) technical and systemic problems impeding accurate and reliable matching were formidable, and (3) cases identified for examination using the matching program were less productive than other examination cases.

IRS now considers this program successful, both in terms of its positive effect on voluntary compliance as well as its highly favorable benefit-to-cost ratio. As late as 1976, the Commissioner estimated that a full-scale matching program for individuals would return only \$1.90 for each \$1 of cost. Since then, this benefit-to-cost ratio has increased substantially. IRS' most recent data, covering tax year 1985, for the individual program show that IRS assessed \$32 in taxes for each \$1 spent on the program.

The payor community also had problems adapting to what was an entirely new set of responsibilities for information return reporting. Unlike the 1960s, businesses have now adapted to information return reporting, so the challenge today is to extend existing systems to accommodate corporations rather than designing entirely new systems as was done in the 1960s. Just as the payor community and IRS have worked together over time to make the individual information returns program a success, we

believe that they will also meet the challenges posed by a corporate returns program.

CONCLUSION

We believe that now is the time for a corporate document matching program. Growing budget deficits, increasing corporate noncompliance, and declining audit coverage all point to the need for a matching program similar to the one that has so effectively promoted voluntary compliance and full income reporting for the vast majority of wage earners in this country. Thanks to wage withholding and information reporting, our tax system is very effective in obtaining tax compliance by wage earners.

IRS does not have all the tools needed to deal effectively with business tax noncompliance, and the higher noncompliance rate among small corporations reflects this. The business information returns program is one tool that could help elevate voluntary compliance in this important sector to the levels already achieved by the vast majority of wage earners.

Mr. Chairman, this concludes my prepared statement. We would be pleased to respond to any questions you may have.

METHODOLOGY USED TO ESTIMATE THE BENEFITS
OF A CORPORATE DOCUMENT MATCHING PROGRAM

The benefits we estimated for a corporate document matching program were confined to the amount of additional tax revenue and interest that could be obtained from detecting five types of unreported income--interest, dividends, rents, royalties, and capital gains. We used the results of IRS' audits of small corporations, or those with assets of under \$10 million. IRS also used these data to develop its benefit estimate for a corporate document matching program. We used IRS' estimating assumptions except in a few instances, as noted.

Benefit estimates for small corporations were based on the results of IRS' most recent TCMP sample, which covered tax year 1987 corporate tax returns. This sample consists of about 12,000 of the 19,000 TCMP cases and statistically represents the study universe of 2.3 million small corporations.

IRS used these audits to identify underreporting in the five income types and to estimate unreported income for the total universe. IRS reduced this unreported income amount to account for income that would likely not be found in a document matching

program. First, unreported income that would be found only by auditing a tax return was eliminated. For example, a document matching program would be unlikely to identify technical adjustments, such as catching an overstated purchase price in computing net capital gains income. The match would only cover the sales proceeds. Thus, if the taxpayer claims the correct sales price but overstates the purchase price of the asset, the matching program would not detect the overstatement. Each type of income in the study had a unique factor to eliminate technical adjustments. We also developed a factor to eliminate unreported income that would not be reported on information returns. For example, interest income from loans to shareholders is not reported to IRS because the payor is an individual. Table I.1 shows the details of these reductions for each type of income.

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Table I.1
 Reductions in 1987 Unreported Income for
 Small Corporations, High and Low Estimates

| Type of <u>income</u> | Percent reduced due to | | Percent of residual reduced due to | |
|--------------------------|------------------------|------------|---------------------------------------|------------|
| | technical adjustments | | likelihood of | |
| | <u>High</u> | <u>Low</u> | <u>High</u> | <u>Low</u> |
| Interest | 10 | 10 | 45 | 50 |
| Dividends | 10 | 10 | 10 | 20 |
| Rents | 40 | 40 | 20 | 40 |
| Royalty | 20 | 20 | 10 | 20 |
| Capital gain | 80 | 90 | 5 | 10 |

Unreported income that IRS found without an information return was multiplied by 3.28 to account for unreported income that revenue agents did not find during the audits. IRS developed this factor in a 1981 study in which they determined the impact of information returns on finding individuals' unreported income. We calculated taxes using a 23.7 percent tax rate, which comes from TCMP data on the average tax rate for small corporations. This tax amount was reduced by 11 percent to account for corporations that underreport income but have net

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operating losses. IRS believed that this reduction was necessary to account for unreported income that would not result in additional taxes because a net operating loss results in owing no taxes.

We also increased benefits by about \$294 million to account for taxes that revenue agents in district offices and service centers will recommend after they pursue underreporter cases. IRS insisted that these agents were necessary to identify and correct technical errors made by taxpayers who had underreported their income. This amount also reflects additional revenues that could be expected from agents auditing returns referred due to the match for unreported income. The estimate was obtained by multiplying IRS' historical revenue yields for this work by the number of direct hours IRS estimated it would need for revenue agents.

The last step in our benefit estimating process was to determine how much of the unreported income corporations would voluntarily report if information return reporting were required and IRS had a document matching program. We relied on IRS' estimate that two-thirds of the unreported income would be voluntarily reported, while the rest would be found in a document matching program.

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Because we made estimates of benefits for 1995 and beyond, we increased benefits to account for inflation. We assumed that net income, and potentially unreported income, would increase by 5 and 6 percent a year for the low and high estimates, respectively. We also added 10-percent interest to all benefits that were identified through matching or obtained from revenue agents. This 10 percent reflects average IRS interest charges.

Tables I.2 and I.3 summarize our high and low estimates, respectively, of the program's costs and benefits. As noted above, the differences between these two estimates are based on different assumptions about technical issues, percent of income reported on information returns, and the estimated increase in net income. Each table covers 1993 through 1999 and separates the benefits between those obtained from enhanced voluntary compliance and those from document matching.

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Table 1.2:
Summary of Costs and Benefits
From a Corporate Document Matching Program
High Estimate
 (MILLIONS OF DOLLARS)

| <u>Year</u> | <u>Benefits</u> | | | <u>Cost</u> | <u>Benefit</u> |
|-------------|------------------|-----------------|----------------|-------------|----------------|
| | <u>Voluntary</u> | <u>Matching</u> | <u>Total</u> | | <u>Cost</u> |
| 1993 | \$ 410.2 | | \$ 410.2 | \$ 88.8 | 5:1 |
| 1994 | 434.8 | | 434.8 | 63.0 | 7:1 |
| 1995 | 460.9 | \$ 638.7 | 1,099.6 | 69.6 | 16:1 |
| 1996 | 515.9 | 677.0 | 1,192.9 | 71.4 | 17:1 |
| 1997 | 546.9 | 717.6 | 1,264.5 | 73.7 | 17:1 |
| 1998 | 579.7 | 728.7 | 1,308.4 | 77.1 | 17:1 |
| 1999 | <u>613.1</u> | <u>772.5</u> | <u>1,385.6</u> | <u>80.5</u> | <u>17:1</u> |
| TOTAL | \$3,561.5 | \$3,534.4 | \$7,095.9 | \$524.1 | |

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Table 1.3:
Summary of Costs and Benefits
From a Corporate Document Matching Program
Low Estimate
 (Millions of Dollars)

| <u>Year</u> | <u>Benefits</u> | | | <u>Cost</u> | <u>Benefit Ratio</u> |
|--------------|------------------|------------------|------------------|----------------|--------------------------|
| | <u>Voluntary</u> | <u>Matching</u> | <u>Total</u> | | |
| 1993 | \$ 276.1 | \$ | \$ 276.1 | \$88.8 | 3:1 |
| 1994 | 289.9 | | 289.9 | 63.0 | 5:1 |
| 1995 | 304.4 | 526.1 | 830.5 | 69.6 | 12:1 |
| 1996 | 342.2 | 552.4 | 894.6 | 71.4 | 13:1 |
| 1997 | 359.3 | 580.0 | 939.3 | 73.7 | 13:1 |
| 1998 | 377.3 | 582.7 | 960.0 | 77.1 | 13:1 |
| 1999 | <u>395.0</u> | <u>611.8</u> | <u>1,006.8</u> | <u>80.5</u> | 13:1 |
| TOTAL | \$2,344.2 | \$2,853.0 | \$5,197.2 | \$524.1 | |

TECHNICAL ISSUES IN A
DOCUMENT MATCHING PROGRAM

In its June 1991 report, IRS discussed several technical issues that could impede a corporate document matching program, and in its costing assumptions proposed ways to overcome them. These issues are discussed below.

- Erroneous underreporter cases may be generated when calendar year information returns are matched to fiscal year tax returns. In its study, IRS found that about 40 percent of the information return income that did not match the tax return income was due to the corporation reporting income on a fiscal year basis. One proposed solution to this matching problem would be to require that information returns for income earned by corporations reflect income on a monthly basis with an annual total. In another solution, IRS would require the taxpayer to attach a schedule to the tax return that indicates how the books were reconciled to the information return.

- Erroneous underreporter cases may be created because information returns report payments made using the cash method of accounting, while corporations may report their

income for income tax purposes using the accrual accounting method. To resolve this problem, IRS proposes that taxpayers be required to use the cash basis for the income subject to matching. We prefer an option that would reconcile the two.

- Current law exempts information reporting on corporate income. To remedy this, Congress would have to change the Internal Revenue Code to require payors to file information returns on the types of corporate income that would be included in a matching program.
- Erroneous mismatches would occur because pension and profit-sharing plans and employee benefit programs use their corporate sponsor's employer identification number, but earnings from these programs are not taxable to the sponsor. To resolve this problem, IRS proposes that payors be required to identify on the information return the tax status of the entity, such as a corporation or pension plan.
- Unreported interest and dividend income may not show up in a matching program because corporate income from foreign sources could mask the domestic income subject to information reporting. IRS' proposed solution to this

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problem is to require corporations to report foreign and domestic source interest and dividend income separately.

- Consolidated income tax returns present two document matching problems. First, the information returns for all subsidiaries included in the consolidated return must be aggregated by income type and then matched to the consolidated tax return to determine underreported income. Second, because corporations eliminate transactions between members of the group when preparing tax returns, information returns on these transactions would overstate the proper income. To address the first problem, IRS proposed that a cross-reference file be developed to identify parent-subsubsidiary affiliations. This file could then be used to aggregate the income reported in information returns. To address the second issue, IRS proposed excluding transactions between consolidated group members from information reporting.

- Potential mismatches can occur when a corporation functioning as a nominee or middleman receives information returns from payors for this income. Since the income does not belong to the corporation, it does not have to report the income on the corporate tax return. IRS proposed to have nominees certify to payors their nominee status so that

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the payor would not issue information returns to the nominee.

- Corporations are not currently required to list the names of payors of interest and dividend income. Without such a listing, IRS would not know the source of the unreported income, and in its notice to the corporation would not be able to cite the specific income that was underreported. To solve this problem, IRS needs to develop a schedule similar to the Schedule B currently required for individuals.

STATUS OF OTHER IRS INFORMATION RETURNS INITIATIVES

IRS undertook two other initiatives dealing with business information returns at the time it began its corporate document matching study. Under one initiative, IRS developed a cross-reference file so that information returns received under sole proprietors' employer identification numbers could be matched with their individual income tax returns, which are filed under their Social Security numbers. IRS uses this file to help identify proprietors who fail to file tax returns or underreport income. In its 1990 individual nonfiler program, IRS used this cross-reference file to identify over 28,000 sole proprietors who failed to file tax returns for tax year 1988. As of December 1990, we estimated that over 11,000 of these cases had been resolved, resulting in IRS obtaining 8,500 additional returns with net assessments totaling over \$31 million. These returns have been obtained primarily through IRS' correspondence program, one of the least costly approaches for pursuing nonfilers. IRS could not provide us with data on the results of using the cross-reference file to identify underreporters.

The second initiative was a test of using information returns to identify corporations and partnerships that did not file tax returns. The test used a sample of 1,610 potential business

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nonfilers from 9 district offices. IRS concluded that using information returns to identify nonfiling partnerships and corporations is only marginally successful when pursued by field investigation. However, IRS plans to study the cost effectiveness of using a correspondence program to secure delinquent returns from partnerships and corporations that do not file. IRS plans to complete the study by September 1992.

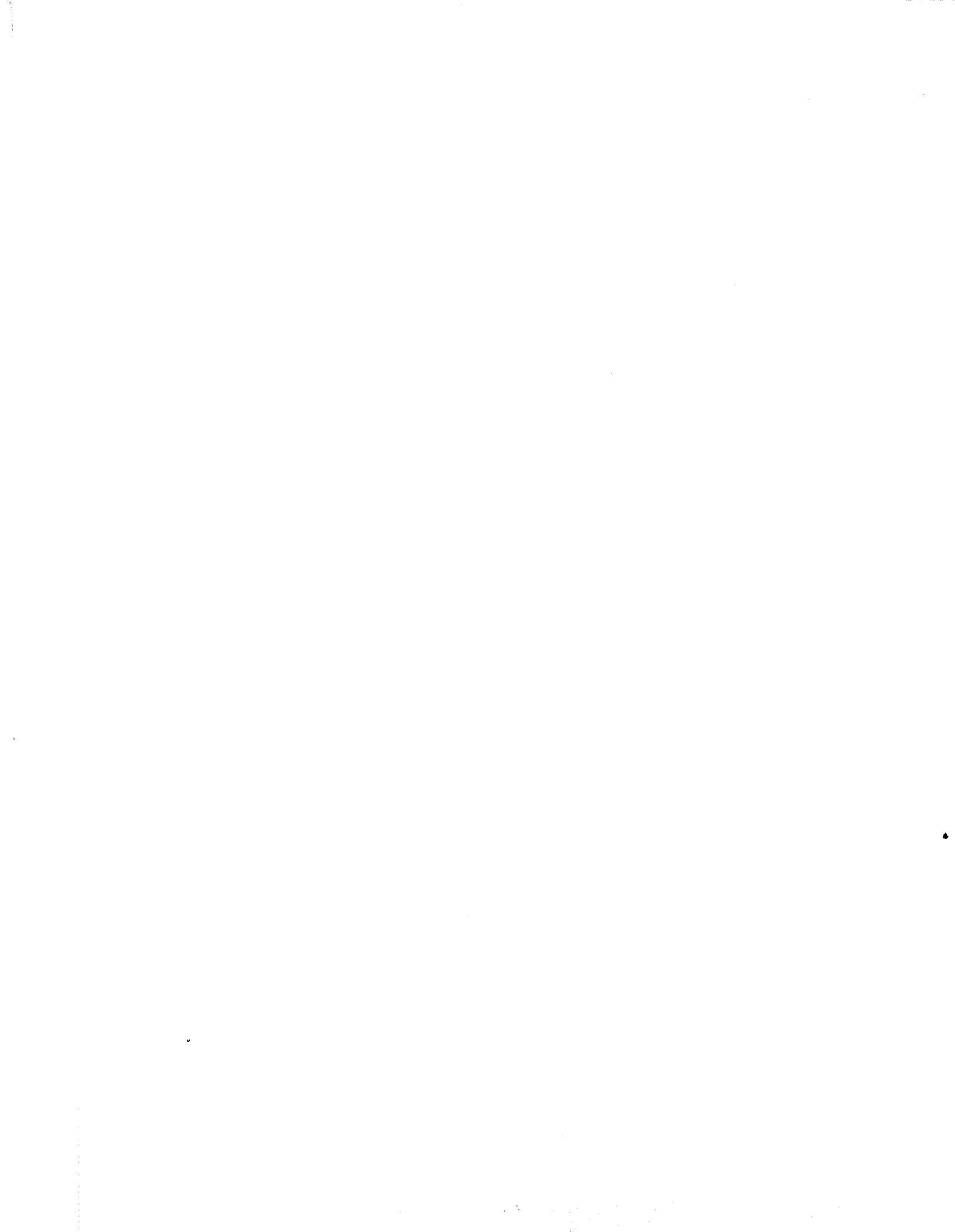
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