

GAO

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

August 1993

TAX
ADMINISTRATION

Computer Matching
Could Identify
Overstated Business
Deductions



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The Honorable John M. Spratt, Jr.
Chairman, Commerce, Consumer, and
Monetary Affairs Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to the request of the former Chairman that we determine what new benefits the Internal Revenue Service (IRS) can derive from more than 1 billion information returns (e.g., Forms W-2 and 1099) that businesses file annually. IRS computer matches these returns with tax returns to generate billions of dollars in additional taxes from individuals (i.e., payees) who underreport income or fail to file tax returns. However, IRS does not do computer matches with business tax returns to detect any overstated deductions or unfiled information returns. IRS attempts to detect such noncompliance through audits.

This report discusses the feasibility of IRS detecting such noncompliance by using computer matching rather than solely by using audits. Matching, if it proves to be feasible, would compare expenses (or payments) that businesses deducted on their tax returns with the same expenses they reported on information returns (e.g., wages on Form W-2). If the amounts differed significantly, IRS would send letters to the businesses asking for an explanation. Because this match would focus on the payor rather than payee, we refer to it as a "reverse match."

IRS has found that businesses of all sizes overstate deductions or fail to file information returns. Accordingly, if a reverse match were feasible, it could apply to all businesses. However, this report focuses on small businesses, which we define as sole proprietors and small corporations (those with less than \$10 million in assets). IRS has information available through its Taxpayer Compliance Measurement Program (TCMP) to test the usefulness of a reverse match for small businesses but not large corporations.¹

¹TCMP measures noncompliance through rigorous audits of a random sample of taxpayers. The most recent audits covered 1987 for small corporations and 1988 for sole proprietors (i.e., self-employed individuals). TCMP results on partnerships were outdated (i.e., from 1981) and thus excluded. IRS does not do TCMP audits for large corporations (i.e., those with assets of \$10 million or more).

To determine the feasibility of a reverse match, we analyzed case files from selected TCMP audits of small corporations and sole proprietors at two IRS service centers in which IRS detected overstated tax deductions for one of four expenses—wages, rents, pension plan contributions, and services. For example, we analyzed 73 audits of small businesses that overstated wage deductions. We selected these four types of deductions because they were more likely to be reported on information returns, providing the best opportunity to test the feasibility of reverse matching. We also analyzed IRS' databases on all recent TCMP audits to determine the extent that all small businesses overstated these four deductions and two others—interest and bad debts—that have potential for a reverse match.

Results in Brief

Small business tax noncompliance is a serious problem. IRS' most recent TCMP audits showed that small corporations in 1987 and sole proprietors in 1988 overstated their deductions by an estimated \$40 billion. The six deductions that we studied—wages, rents, interest, services, pension plan contributions, and bad debts—accounted for about \$14 billion of the total. The TCMP results also showed that these small businesses did not file required information returns on at least an estimated \$19 billion in payments to individual taxpayers. In appendix I, we provide more details on these and other estimates.

Reverse matching offers one way for IRS to identify businesses that overstate wage deductions or do not file all required Forms W-2. We found that such matching would have been feasible because it would have identified 52 of the 73 small businesses in our sample that overstated wage deductions in either tax years 1987 or 1988. The remaining noncompliance could be detected only by examining the businesses' books and records. Also, such matching would have identified all 12 of the 73 businesses that failed to report all wages on Forms W-2.

If IRS were to develop a reverse match for wages, tax revenues should increase. Our analysis of TCMP databases and selected audit cases showed that a reverse match could have identified some overstated wage deductions (an estimated \$3.2 billion) by the small businesses and unreported wages on the required Form W-2 (an estimated \$4.8 billion) for small corporations only. Increasing business compliance with Form W-2 is important for tax administration. IRS uses the form to detect individual taxpayers who fail to report all wages. The Social Security Administration (SSA) uses Form W-2 to ensure that individuals receive correct social security benefits.

Reverse matching for the other five types of deductions we reviewed is less feasible now because of various factors. For example, businesses are required to issue information returns on various payments to individuals and sole proprietors but not to corporations. Thus, amounts that businesses deducted for services would not necessarily match amounts they reported on information returns. Also, businesses do not always report the proper Employer Identification Number (EIN)—a key variable for any effective matching.²

We believe these limitations can be reduced, if not overcome, as IRS modernizes its computer operations. Other limitations, such as the reporting gap between tax returns and information returns, would require changes in legislation or regulations. Given the \$40 billion in overstated deductions from just small businesses, significant benefits would likely emerge from expanding reverse matching beyond wages to include services and other deductions we reviewed. However, the costs and burdens on taxpayers to file more information returns would have to be considered.

We recommend that IRS do a limited test of a reverse matching program on wages while it addresses the limitations to an expanded program for other deductions, such as for services and bad debts. IRS officials said that they agreed that reverse matching for wages is feasible and they are considering how to develop such a program as well as how to address the limitations.

Background

Although audits can detect when businesses overstate deductions or fail to file information returns, they are costly and cover only a small portion of businesses. For example, in fiscal year 1991, IRS audited only 186,000, or about 2 percent, of the 9.1 million tax returns that small corporations and sole proprietors filed. A less expensive and intrusive method for detecting such noncompliance would significantly improve our tax system.

Businesses are required to report certain payments they make. For example, wages that businesses pay to employees are to be annually reported on Form W-2 (an information return) and on Form 941 (Employer's Quarterly Tax Return). Other payments, such as for interest, rent, and services that are made to individuals or unincorporated businesses (e.g., sole proprietors), are to be reported to IRS on Forms 1099 (information returns). However, such payments to corporations generally

²IRS assigns EINs to track the tax transactions of taxpayers.

do not have to be reported. Business contributions to employee pension plans are to be reported annually on Form 5500 (Annual Return/Report of Employee Benefit Plan).

These reported payments, as well as other payments, may also be claimed as deductions on business income tax returns. For example, wages reported on Forms W-2 and 941 may be reported on the corporate tax return lines for either salaries and wages, compensation of officers, or cost of labor deductions. Sole proprietors may report these payments on lines for wages or cost of labor. Rent payments, which may be reported on Form 1099, can be deducted on the tax return line for rents. Small corporations with pension contributions reported on Form 5500 may deduct the expense on the tax return line for pension plans.

IRS stores tax return and information return data in separate computer master files. However, IRS is developing new data processing systems under its \$23 billion computer modernization program—Tax Systems Modernization (TSM). TSM is expected to form an integrated electronic environment in which all systems share data automatically. As a result, IRS expects fundamental changes in the way it processes, stores, retrieves, and uses data. TSM is being implemented through a series of projects and is expected to be fully operational in 2008.

IRS uses information return data to verify whether individuals who received payments properly reported them as income on their tax returns. For example, IRS computer matches data on information returns with individual tax returns to identify unreported income or unfiled tax returns. Such matching has generated additional tax assessments and prompted high levels of compliance, such as 99.6 percent of wages being accurately reported on tax returns. Although this computer matching has been cost-effective for individual “payees,” IRS has no matching program to identify deductions that business “payers” overstate on tax returns.

Objective, Scope, and Methodology

Our objective was to determine whether it is feasible for IRS to use information returns in a reverse matching program to detect businesses that overstate deductions on tax returns or that fail to file all required information returns. To determine the feasibility of a reverse match, we did detailed analyses of selected TCMP audits and analyzed IRS' databases on overall TCMP results for small corporations in tax year 1987 and sole proprietors in tax year 1988.

To do our analyses of TCMP audits, we selected all TCMP audits that met certain criteria in two IRS service centers. We analyzed four types of overstated deductions—wages, rents, services, and pensions—because we anticipated that more of these expenses would be reported on information returns. Our analyses focused on deductions that were overstated in significant amounts. For example, we analyzed wage, rent, and service deductions that were overstated by \$1,000 or more. For pensions, we analyzed deductions overstated by \$100 or more and entirely disallowed by the IRS examiner.

Ultimately, we analyzed 189 TCMP audits of small corporations for tax year 1987 and sole proprietors for tax year 1988 from the Fresno, CA, and Ogden, UT, service centers. Our analysis identified 199 overstated deductions, including (1) 187 wage, rent, or service deductions and (2) 12 pension deductions. Of the 187 overstated deductions, 73 were for wages, 76 were for rent, and 38 were for services (e.g., commissions or cost of labor).

For the four deductions in our sample, we did manual reverse matches. That is, we matched the deduction line on the tax return with the payment data reported to IRS on an information return (e.g., Forms W-2, 1099, 5500) or Form 941. For small businesses that deducted pension contributions, we also checked whether IRS had a record of an approved pension plan or previous contributions. We also reviewed TCMP audit workpapers to gain insights on overstated deductions. Our matching results cannot be generalized to all sole proprietors and small businesses. In appendix I, we discuss our methodology and the number of small corporation and sole proprietor cases we requested and analyzed from each service center.

We also analyzed IRS' overall TCMP databases to determine the extent to which small businesses overstated these four deductions. This analysis covered two other deductions—interest and bad debts—that have potential for a reverse match.³ To analyze the TCMP databases, we also compared the amounts that small businesses reported on Forms W-2 and 1099 with the related amounts deducted for wages, rents, and services on various tax return lines.

We interviewed IRS Examination officials from the National Office and San Francisco district office on the usefulness and limitations of reverse

³We did not do detailed analyses for (1) bad debt deductions because information returns are not required or (2) interest because initial testing uncovered limitations to using Forms 1099 to identify overstated interest deductions. We discuss these limitations in a later section.

matching and on TSM. We did our field work from July 1992 through March 1993 in accordance with generally accepted government auditing standards.

Business Noncompliance Is Significant

By using TCMP database results on an estimated 15.7 million sole proprietors and small corporations, we estimated that such small businesses overstated \$40 billion among all deductions. For the six deductions we reviewed, we estimated that small businesses overstated \$14 billion—2 percent of the estimated \$613 billion they deducted. Of the estimated 10.5 million small businesses that claimed the estimated \$613 billion, we estimated that 4.5 million (42.9 percent) overstated 1 or more of the deductions.

Table 1 shows our estimates of the six overstated deductions (see app. I for more details). Because IRS does not do TCMP audits of large corporations, IRS has no statistically valid data available on their overstated deductions.

Table 1: Overstated Business Deductions Among Small Corporations for 1987 and Sole Proprietors for 1988

Dollars in millions			
Overstated deductions	Small corporations	Sole proprietors	Total
Wages ^a	\$2,585.3	\$629.5	\$3,214.7
Pensions	293.6	34.8	328.3
Rents	875.5	1,291.2	2,166.7
Interest	1,103.7	717.0	1,820.7
Services ^b	1,456.0	3,465.1	4,921.1
Bad debts	986.8	227.6	1,214.4
Total	\$7,300.9	\$6,365.0	\$13,665.9

Note 1: Our estimates are accurate at the 95-percent confidence level. Upper and lower limits for all estimates are in appendix I.

Note 2: Totals may not add due to rounding.

^aWages include wage deductions for sole proprietors and salaries and wages plus officers' compensation for small corporations.

^bServices include deductions for advertising, repairs, and cost of labor. Sole proprietors' deductions also include commissions and legal and professional fees.

Source: IRS' TCMP data.

Using TCMP data, we also estimated that small businesses failed to file information returns for about \$19 billion in just wage, rent, interest, and service payments, as shown in table 2.

Table 2: Estimated Annual Amount of Small Business Deductions Not Reported on Information Returns as Required

Dollars in billions			
Payment type ^a	Sole proprietors	Small corporations	Total
Wages	N/A ^b	\$4.8	\$4.8
Rent	1.5	4.0	5.4
Services	4.1	3.6	7.7
Interest	0.3	0.5	0.8
Total^c	\$5.9	\$12.9	\$18.8

Note: Estimates are based on TCMP results on sole proprietors for 1988 and on small corporations for 1987. Estimates are accurate at the 95-percent confidence level. Upper and lower limits for all estimates are in appendix I.

^aBad debts are excluded because information returns are not required for these expenses. Pensions are excluded because IRS' TCMP did not have data on the amount of unreported pension contributions on Form 5500.

^bWe could not estimate wages that sole proprietors failed to report on Forms W-2 because IRS did not collect that data during the 1988 TCMP audits.

^cTotals may not add due to rounding.

Source: IRS' TCMP data.

Filing all required information returns is important because IRS' and our studies have found that the returns improved the payee's voluntary compliance in reporting the payment. While the extent of improvement varied from study to study, IRS found that individual taxpayers reported 97 percent of the income that appeared as service payments on Forms 1099. Without the forms, they reported 83 percent of the income—a decline of 14 percentage points.

If taxpayers did not report 14 percent (\$2.63 billion) of the \$18.8 billion for payments not reported on Forms 1099, tax revenue losses may have been significant. Tax losses may have been \$394 million at a 15-percent tax rate or \$736 million at a 28-percent tax rate.

Reverse Matching Can Identify Overstated Wage Deductions and Unfiled Forms W-2

Our analysis of the TCMP small corporation database and of 73 TCMP audits of small businesses indicated that a reverse matching program could identify businesses that potentially overstated wage deductions or did not file all Forms W-2. This program would match the amount of wages that a business deducted on its tax return with the amount it reported on Forms W-2.

By analyzing IRS' TCMP small corporation database, we estimated that 249,594 (43 percent) of the 584,354 small corporations filing calendar year tax returns for 1987 reported exactly the same amount of wages on Forms W-2 that they deducted on their tax returns as salaries and wages and as officers' compensation. We found that these corporations generally deducted the correct wage expenses on their tax returns and reported all required Form W-2 data.

Of the remaining 334,760 small corporations with wage deductions that did not equal wages reported on Forms W-2, we estimated how many of them deducted significantly more wages compared to the wage amounts they reported on Forms W-2. We found that an estimated 61,568 (11 percent of the total 584,354) had wage deductions that exceeded their reported wages by more than 10 percent. These 61,568 small corporations accounted for \$204 million (32 percent) of the estimated \$632 million in overstated wage deductions and \$453 million (36 percent) of the estimated \$1.3 billion in wages that were not reported on Form W-2 by all small corporations that filed tax returns on a calendar year basis.⁴

Our review of 73 TCMP wage cases showed that it is feasible to begin a reverse matching program for wages. We found that examiners disallowed part or all of the wage deductions when a business could not substantiate it. In substantiating the deductible amount, examiners used Forms W-2 and 941.

We found that reverse matching could have identified overstated wage deductions by 52 of the 73 small businesses. For the remaining 21, either audits would be required to detect the noncompliance or more information would be needed in the TCMP workpapers to allow us to determine the feasibility of reverse matching. Table 3 shows how often IRS could have used reverse matching to identify the overstated wage deductions.

⁴The accuracy of our estimates of overstated deductions and unfiled Forms W-2 ranged from plus or minus 21.7 percent for total overstated wage deductions to plus or minus 46.2 percent for unfiled information returns of corporations with wages that were more than 10 percent greater than W-2 wages. We include upper and lower limits of all estimates in appendix I.

Table 3: Number of Cases in Which Reverse Matching Could Have Detected Overstated Wage Deductions

Results	Type of small business		Total
	Small corporation	Sole proprietor	
Could detect	27	25	52
Could not detect	8	5	13
Could not determine	7	1	8
Total	42	31	73

In 19 of the 52 cases in which reverse matching could have detected overstated wage deductions, we found that the wage deduction allowed by an IRS examiner equaled the amount reported separately to IRS by the business as wage payments. Two examples follow:

- A small corporation deducted \$64,465 in salaries and wages but reported only \$41,653 on Forms 941. IRS examiners disallowed the difference of \$22,812 based on the amount reported on Forms 941 and the lack of any other taxpayer records to substantiate an additional \$22,812.
- A sole proprietor deducted \$35,941 in wage expenses on his tax return but reported only \$24,830 on his Forms 941. IRS examiners disallowed the difference of \$11,111, which the taxpayer could not substantiate.

In 28 of the 52 cases, reverse matching could have identified overstated wage expenses even though the reported wage payments did not exactly match wage deductions that the examiner allowed. Some of the reasons the payments and deductions did not match were that the businesses (1) did not report all wages payments on Forms W-2 or 941, (2) reported other expenses on wage deduction lines or wage expenses on other deduction lines, and (3) deducted wage expenses based on the accrual accounting method.⁵ Two examples follow:

- A small corporation deducted \$59,352 in wages on its tax return, but reported only \$47,171 on its Form 941. Focusing on this \$12,181 difference, the examiner found that \$3,465 of deducted wages should have been deducted as contract labor. The remaining \$8,716, which the corporation could not substantiate, was disallowed.
- A small corporation deducted \$552,614 in wage expenses on its tax return using accrual accounting and reported \$528,164 in wages on Forms 941. To reconcile the difference, the examiner added an end-of-the-year accrual of

⁵The accrual method recognizes income when it is earned (not when it is received) and an expense when an obligation to pay a debt is incurred. Because information returns use the cash accounting method, information return amounts may differ from amounts deducted on tax returns filed using an accrual method.

\$22,768 to the reported Form 941 amount and disallowed the remaining \$1,682 that could not be substantiated.

In the other five cases, the IRS examiners disallowed the entire wage deduction because the businesses did not file any Forms W-2 or 941. In one such case, the TCMP examiner disallowed \$3,300 that a sole proprietor had deducted for wages paid.

In the 13 cases in which reverse matching would not have identified an overstated wage deduction, we found that IRS would have to do an audit to detect the overstated deduction. The examiners would still have to review taxpayer records and other data. For example, audits would be needed to identify businesses that (1) paid excessive compensation to officers, (2) paid for services that were not performed, or (3) claimed wage expenses that should have been charged to a related corporation.

Reverse matching also could identify businesses that deducted wage expenses but did not file all Forms W-2. Our analysis of the TCMP cases that had overstated wage deductions indicated that 12 of the 73 small businesses failed to report wages on Forms W-2. Failure by businesses to report wages on Form W-2 has negative effects. Without the wage data, SSA cannot ensure that eligible individuals receive social security benefits, and IRS cannot easily ensure that individuals file tax returns and fully report their income, as required.

If IRS were to begin a reverse match on wages, any attempt by businesses to overstate their wage deductions and avoid detection by filing false Forms W-2 would likely be detected through IRS' underreporter computer match. This match is designed to detect payees who did not fully report income on their tax returns. When a payee tells IRS that the wages were never paid, IRS' procedures require IRS staff to attempt to contact the business that filed the Form W-2 for an explanation.

Reverse Matching Could Be More Feasible for Other Expenses if Various Changes Are Made in the Tax System

Although businesses overstated deductions for the five other expenses we studied, we found reverse matching for them is less feasible because of various limitations. We discuss our findings in the following sections.

Gaps in Reporting

Tax law generally does not require businesses to file information returns on payments made to corporations. Even when businesses are required to file information returns on payments made to individuals, they do not have to report all payments. For example, annual service payments and rent payments of less than \$600 do not have to be reported.

Such reporting gaps were evident when we analyzed TCMP databases. IRS examiners identified the sole proprietors and small corporations in IRS' TCMP who were required to file information returns. Using their results on these small businesses, we estimated that

- 0.8 million of the 4.3 million small businesses with a rent deduction were required to file related information returns,
- 1.9 million of the 8.6 million small businesses with a deduction for service payments were required to file related information returns, and
- 0.3 million of the 3.7 million small businesses with a deduction for interest were required to file related information returns (see app. I for confidence intervals).

Another reporting gap involves the deductions for bad debts. As table 1 shows, small businesses overstated deductions for bad debts by \$1.2 billion. However, information reporting is not generally required for bad debts. In a February 1993 report, we discussed the need to require certain government agencies and the private sector to issue information returns when forgiving bad debts.⁶ Without any information reporting, reverse matching for bad debt deductions would not be possible.

Different Reporting Formats

We found that differences in the way expenses are reported on tax returns versus information returns limited the feasibility of reverse matching. For example, tax returns for sole proprietors and corporations both have lines on which to report the cost of labor deduction. However, these lines may include not only wages reported on Forms W-2 but also service payments reported on Forms 1099. In addition, service payments reported on Forms 1099 may be deducted elsewhere on tax returns, such as on lines for legal, advertising, or professional fees. Such reporting differences precluded us from using the Forms 1099 to identify overstated cost of labor deductions in 22 of the 23 TCMP cases we reviewed.

⁶Tax Administration: Information Returns Can Improve Reporting of Forgiven Debts (GAO/GGD-93-42, Feb. 17, 1993).

EIN Problems for Pensions

One reason the amount a business deducts for pension plan contributions may not match the amount on IRS' records is that the business did not report its proper EIN. Another reason is that two entities may contribute to the same pension plan, but IRS only credits one with a contribution. For example, several businesses may contribute to the same plan established under only one business' EIN on IRS' pension database—the Employee Plans Master File (EPMF). When these businesses claim a pension deduction on their tax returns, IRS can only identify an approved pension plan for one of these businesses on EPMF.

Our analysis of the TCMP database showed 69 audits in which the examiner disallowed a small corporation's entire pension plan contribution of \$100 or more. We found that IRS' EPMF had no record of an approved pension plan or pension contribution for 18 of the 69 corporations.

We were able to do detailed case reviews for 8 of the 18 small corporations to identify the reasons they were missing from EPMF. In six of the eight cases, the corporations were missing because they had not established an approved pension plan as required. In the other two cases, the corporations proved that they had approved pension plans. IRS officials could not determine why the two corporations were not listed on EPMF but said they may be listed under a different EIN or name. IRS officials said this problem would interfere with a reverse matching program.

We also found that a reverse match cannot be used to identify a common overstated pension deduction—those contributions made after the due date for filing the tax return (I.R.C. section 404(a)(6)). Although Form 5500 includes the contribution date, this date is not recorded on EPMF. As a result, IRS could only detect these late contributions in audits by examining cancelled checks and related records.

Cash Versus Accrual Accounting and Calendar Versus Fiscal Year

Other limitations to reverse matching involve corporations that file information returns on a calendar year and cash accounting basis but file tax returns on a fiscal year and accrual accounting basis. For example, a corporation could deduct business payments made from a July 1 through June 30 fiscal year. As a result, its deductions would not match its reported payments on information returns that are filed for the January to December calendar year. However, the quarterly Forms 941 can be compared to those fiscal years that end on a calendar year quarter.

Under accrual accounting, a corporation can properly deduct payments on its tax return but not make some of the payments until the following tax year. Therefore, payments reported on information returns could be lower than the deductions for these payments on the tax return. We discussed these two limitations and ways IRS could reduce them in a previous report on the benefits of a corporate document matching program.⁷

These two limitations would rarely affect reverse matching for sole proprietors because they usually file tax returns for a calendar year and use cash accounting. These limitations interfered slightly with the reverse matching of wages that we did for small corporations in our sample.

For example, in 11 TCMP cases we reviewed, the fiscal year of the small corporation ended on a calendar year quarter, allowing us to compare wages reported on quarterly Forms 941 with wage deductions. Moreover, by analyzing the TCMP database, we estimated that about 70 percent of small corporations file tax returns ending on a calendar year quarter. We also found that accrual accounting only affected 12 of 42 small corporation cases we reviewed. In these 12 cases, we were generally able to identify overstated deductions or at least to reconcile wage deductions to reported wage payments.

Limitations to Reverse Matching Could Be Addressed Under TSM and Other Changes

The scope of our study did not include a thorough analysis of the ways that IRS could resolve these limitations to reverse matching. However, we believe that computer modernization and other proposed changes to the nation's tax system would help.

An IRS official told us that a full-scale reverse matching program would require the development of a new computer system to (1) capture and store data from tax returns and information returns, (2) sort information documents by business payor, and (3) retrieve and consolidate the data needed to do the match.

Because TSM should greatly expand IRS' computer systems, IRS should have the capability to receive, store, and process the tax and information return data that would be needed for a reverse matching program. For example, additional computer capacity would be needed to process the increased number of information returns that would result from any changes to close the gap in information reporting.

⁷Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs (GAO/GGD-91-118, Sept. 27, 1991).

As IRS modernizes its computer system, it also intends to improve voluntary compliance by simplifying tax forms and procedures. One way that IRS could increase business' reporting compliance would be to ensure that the data reported on information returns can be matched to specific tax return deduction lines. Doing so also would facilitate reverse matching. IRS could change corporate and sole proprietor returns so that the cost of labor is claimed on either a wage line supported by Forms W-2 or on a service payment line supported by Forms 1099. Changes such as these would create the one-to-one correspondence necessary to match information return data with tax return deductions.

TSM also could provide the capability to address problems in a reverse match on pension plans. For example, when two entities contribute to a plan, IRS could more easily create a cross-reference file to associate a pension plan contribution with both entities. IRS already has such a file to associate tax returns and information returns for sole proprietors who have both an EIN and Social Security Number (SSN). Also, IRS could identify late contributions if it first recorded the date of the contribution as reported on Form 5500.

Other changes also could reduce the gap in information reporting. The President's tax proposals include a requirement that businesses file information returns on service payments to corporations. We recently reported on the benefits of such increased reporting.⁸ Although this increased reporting would impose more cost and burdens on taxpayers, we believe that it also would greatly increase the feasibility of a reverse matching program for service expenses. We have also reported on the benefits of increased information reporting for other types of payments to corporations and for bad debts.⁹

Conclusions

IRS can derive major new benefits from the more than 1 billion information returns that it receives annually if it develops a successful reverse matching program for the 21st century. Currently, IRS audits very few businesses, allowing billions of dollars in overstated deductions and unfiled information returns to go undetected.

⁸Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992) and Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations (GAO/GGD-92-130, Sept. 22, 1992).

⁹GAO/GGD-93-42, February 17, 1993, and GAO/GGD-91-118, September 27, 1991.

Our study showed that reverse matching for wages is feasible and could generate significant tax revenues. Reverse matching for other deductions has potential but is less feasible because of various limitations, such as the gap in information reporting. However, we believe that TSM and other proposed changes can help reduce many of these limitations. For example, if the proposal to close the gap in information returns on service payments is implemented, we believe a reverse match for services could prove to be feasible—particularly if IRS changes tax return lines to consolidate deductions for service payments. Similarly, reverse matching for bad debts should be feasible if Congress requires businesses to file information returns on bad debts.

Recommendations

We recommend that the Commissioner of Internal Revenue do a limited test of a reverse matching program for wages. If the test proves cost-effective, we recommend development of a full-scale program.

If businesses are required to begin filing information returns on service payments to corporations or on bad debts, we recommend that the Commissioner of Internal Revenue do a limited test of reverse matching programs for these deductions. If they prove cost-effective, we recommend development of full-scale programs.

We also recommend that the Commissioner, when implementing TSM, consider what actions are necessary to overcome the limitations to reverse matching programs for other deductions, such as pensions, rents, and interest.

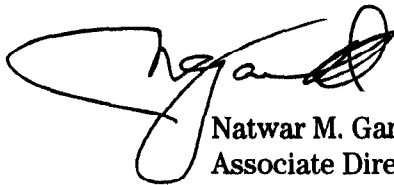
Agency Comments

We discussed our recommendations with responsible IRS officials. They agreed to test reverse matching for wages as part of a test on ways to use information returns and tax returns as well as other information. They also agreed to the other recommended tests and to explore ways to overcome the limitations to reverse matching, particularly as TSM progresses.

As agreed with the Committee, unless you publicly announce the contents of this report earlier, we plan no further distribution for 30 days. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We also will make copies available to others upon request.

The major contributors to this report are listed in appendix II. If you have any questions, please contact me at (202) 272-7904.

Sincerely yours,



Natwar M. Gandhi
Associate Director, Tax Policy
and Administration Issues

Contents

Letter		1
Appendix I		20
GAO Sampling and	Estimates From TCMP Databases	20
Data Analysis	Judgmental Samples of TCMP Cases to Test the Feasibility of	28
Methodology	Reverse Matching	
Appendix II		30
Major Contributors to		
This Report		
Tables	Table 1: Overstated Business Deductions Among Small Corporations for 1987 and Sole Proprietors for 1988	6
	Table 2: Estimated Annual Amount of Small Business Deductions Not Reported on Information Returns as Required	7
	Table 3: Number of Cases in Which Reverse Matching Could Have Detected Overstated Wage Deductions	9
	Table I.1: Point Estimates and Confidence Intervals on the Type and Amount of Overstated Deductions for Sole Proprietors	21
	Table I.2: Point Estimates and Confidence Intervals on the Type and Amount of Expenses Not Reported as Required on Information Returns by Sole Proprietors	21
	Table I.3: Point Estimates and Confidence Intervals on Information Filing Requirements for Sole Proprietors With Rent, Service, and Interest Deductions	22
	Table I.4: Point Estimates and Confidence Intervals on the Type and Amount of Overstated Deductions for Small Corporations	23
	Table I.5: Point Estimates and Confidence Intervals on the Type and Amount of Expenses Not Reported as Required on Information Returns by Small Corporations	23
	Table I.6: Point Estimates and Confidence Intervals on Information Filing Requirements for Small Corporations With Rent, Service, and Interest Deductions	24
	Table I.7: Nationwide Estimates of Overstated Wage Deductions for Small Corporations Filing Calendar Year Tax Returns	25
	Table I.8: Point Estimates and Confidence Intervals on the Type and Amount of Overstated Deductions for Small Corporations and Sole Proprietors	26

Table I.9: Point Estimates and Confidence Intervals on Type and Amount of Expenses Not Reported as Required on Information Returns by Small Corporations and Sole Proprietors	27
Table I.10: Point Estimates and Confidence Intervals of Information Filing Requirements for Small Corporations and Sole Proprietors With Rent, Service, and Interest Deductions	27
Table I.11: Number of TCMP Audits Requested and Analyzed by Type of Deduction and Business	29

Abbreviations

EIN	Employer Identification Number
EPMF	Employee Plans Master File
IRS	Internal Revenue Service
SSA	Social Security Administration
SSN	Social Security number
TCMP	Taxpayer Compliance Measurement Program
TSM	Tax Systems Modernization

GAO Sampling and Data Analysis Methodology

In this appendix, we describe the sampling methodology we used in analyzing TCMP databases and the judgment samples of TCMP cases we selected to test the feasibility of reverse matching.

To analyze the databases, we developed statistical estimates called point estimates, which are weighted to account for strata size. Point estimates do not adequately represent statistical results unless they correspond to range estimates stated at a level of confidence. Our estimates were developed at a 95-percent confidence level. The narrower a confidence interval is, the more reliable the estimate.

For example, our point estimate of 584,000 small corporations that deducted wages on calendar year 1987 returns has a range estimate (i.e., confidence interval) of 565,000 to 604,000 at the 95-percent confidence level. This means there is a 95-percent chance that the actual number of corporations filing calendar year 1987 tax returns is between 565,000 to 604,000. It also means there is a 5-percent chance that the actual number is not within this range.

Estimates From TCMP Databases

We developed our estimates using data collected under IRS's TCMP. Under TCMP, IRS selects nationwide, stratified random samples by income group and type of tax return to measure taxpayer compliance. IRS has separate TCMPs for individual taxpayers and small corporations. In some cases, we also combined the TCMP estimates separately developed for small corporations and for nonfarm sole proprietors, using appropriate weights to account for differences in the sizes of the respective populations. For both small corporations and sole proprietors, estimates of overstated deductions do not include deductions that some corporations and sole proprietors understated. The net amounts of the deductions would be somewhat less.

Analysis of the TCMP Database for Sole Proprietor Tax Returns

In the individual TCMP for tax year 1988, IRS selected a stratified sample of 54,088 tax returns, which represents a nationwide population of 104.4 million tax returns. IRS grouped this population by income and type of tax returns into 32 strata. Samples within each TCMP strata were selected independently using unequal probabilities of selection.

Our analysis focused on nonfarm sole proprietors who reported business income and expenses on a Schedule C. The TCMP sample for sole proprietors included 17,048 tax returns. For 11,124 of these returns,

Schedule C income was the major income; these cases are grouped in separate Schedule C strata in the TCMP sample. For the remaining 5,924 returns, Schedule C income was not the major income.

Table I.1 shows the point estimates and the statistical confidence intervals at the 95-percent level for overstated deductions of sole proprietors that we reviewed.

Table I.1: Point Estimates and Confidence Intervals on the Type and Amount of Overstated Deductions for Sole Proprietors

Dollars in millions			
Payment type	Point estimate	Upper limit	Lower limit
Wages	\$629.5	\$775.0	\$483.9
Pensions	34.8	52.8	16.7
Rents	1,291.2	1,448.1	1,134.2
Interest	717.0	846.5	587.4
Services ^a	3,465.1	3,792.0	3,138.1
Bad debts	227.6	302.1	153.1
Total^b	\$6,365.0	\$6,783.8	\$5,946.2

^aServices include tax deductions for advertising, repairs, cost of labor, commissions, and legal and professional expenses.

^bTotals do not add due to rounding.

Source: IRS' TCMP data.

Table I.2 shows the point estimates and statistical confidence intervals at the 95-percent confidence level for expenses that were not reported on information returns by sole proprietors.

Table I.2: Point Estimates and Confidence Intervals on the Type and Amount of Expenses Not Reported as Required on Information Returns by Sole Proprietors

Dollars in billions			
Payment type	Point estimate	Upper limit	Lower limit
Rents	\$1.5	\$1.7	\$1.2
Interest	.3	.4	.2
Services	4.1	4.6	3.6
Total^a	\$5.9	\$6.4	\$5.3

^aTotal may not add due to rounding.

Source: IRS' TCMP data.

Table I.3 shows the point estimates and statistical confidence intervals at the 95-percent level for information filing requirements for sole proprietors.

Table I.3: Point Estimates and Confidence Intervals on Information Filing Requirements for Sole Proprietors With Rent, Service, and Interest Deductions

Type of expense/ filing status	Point estimate	Upper limit	Lower limit
Rent			
Required to file	336,023	369,987	302,059
Not required to file	2,470,548	2,583,815	2,357,280
Total^a	2,806,571	2,922,895	2,690,247
Services			
Required to file	1,160,252	1,214,719	1,105,784
Not required to file	5,815,979	6,020,963	5,610,994
Total^a	6,976,230	7,181,529	6,770,932
Interest			
Required to file	65,606	76,549	54,662
Not required to file	2,199,955	2,303,882	2,096,027
Total^a	2,265,560	2,369,662	2,161,459

^aTotals may not add due to rounding.

Source: IRS' TCMP data.

Analysis of the TCMP Database for Small Corporations

The 1987 TCMP sample for small corporations had 18,138 tax returns and represented a nationwide population of 2.3 million. IRS defines small corporations as those having assets of less than \$10 million on their year-end balance sheet or those not submitting balance sheets. For small corporations, IRS defined 14 strata by asset class and gross income. Samples within each strata were selected independently using unequal probabilities of selection.

Table I.4 shows the point estimates and statistical confidence intervals at the 95-percent confidence level for the overstated deductions of small corporations that we reviewed.

**Appendix I
GAO Sampling and Data Analysis
Methodology**

Table I.4: Point Estimates and Confidence Intervals on the Type and Amount of Overstated Deductions for Small Corporations

Dollars in millions			
Payment type	Point estimate	Upper limit	Lower limit
Wages	\$2,585.3	\$3,050.4	\$2,120.1
Pensions	293.6	369.5	217.7
Rents	875.5	993.4	757.7
Interest	1,103.7	1,286.6	920.8
Services ^a	1,456.0	1,604.5	1,307.6
Bad debts	986.8	1,185.1	788.5
Total^b	\$7,300.9	\$7,876.0	\$6,725.7

^aServices include deductions for advertising, repairs, and cost of labor.

^bTotals may not add due to rounding.

Source: IRS' TCMP data.

Table I.5 shows the point estimates and statistical confidence intervals at the 95-percent confidence level for expenses not reported on information returns by small corporations.

Table I.5: Point Estimates and Confidence Intervals on the Type and Amount of Expenses Not Reported as Required on Information Returns by Small Corporations

Dollars in billions			
Payment type	Point estimate	Upper limit	Lower limit
Wages	\$4.8	\$5.6	\$4.1
Rents	4.0	4.5	3.4
Interest	.5	.7	.4
Services	3.6	4.2	3.0
Total^a	\$12.9	\$14.0	\$11.8

^aTotals may not add due to rounding.

Source: IRS' TCMP data.

Table I.6 shows the point estimates and statistical confidence intervals at the 95-percent confidence level for information filing requirements for small corporations.

**Appendix I
GAO Sampling and Data Analysis
Methodology**

Table I.6: Point Estimates and Confidence Intervals on Information Filing Requirements for Small Corporations With Rent, Service, and Interest Deductions

Type of expense/ filing status	Point estimate	Upper limit	Lower limit
Rent			
Required to file	501,594	519,891	483,298
Not required to file	957,342	979,877	934,806
Total^a	1,458,936	1,481,534	1,436,337
Services			
Required to file	715,927	736,052	695,802
Not required to file	945,865	968,623	923,106
Total^a	1,661,792	1,683,192	1,640,391
Interest			
Required to file	238,865	251,173	226,557
Not required to file	1,214,637	1,237,607	1,191,667
Total^a	1,453,502	1,475,864	1,431,139

^aTotals may not add due to rounding.

Source: IRS' TCMP data.

Table I.7 shows the point estimates cited in the report and confidence intervals at the 95-percent level for overstated wage deductions and unfiled Forms W-2 by specific groups of small corporations.

**Appendix I
GAO Sampling and Data Analysis
Methodology**

Table I.7: Nationwide Estimates of Overstated Wage Deductions for Small Corporations Filing Calendar Year Tax Returns

Dollars in millions

Description	Point estimate		Upper limit	Lower limit
	Amount	Percent		
Number of small corporations with wage deductions				
Equaled amounts on their Forms W-2 ^b	249,594	42.7%	264,943	234,695
10 percent or greater than amounts on their Forms W-2	61,568	10.5	69,253	53,884
All others	273,192	46.7	268,602	259,581
Total	584,354	*	604,178	564,529
Amount of overstated wage deductions				
10 percent or greater than amount on Forms W-2	\$204	32.3	\$286	\$123
All others	428	67.6	538	317
Total	\$632	*	\$769	\$495
Wage amounts not reported on Forms W-2				
Deductions were 10 percent or greater than amounts on Forms W-2	\$453	35.8	\$663	\$244
All others	810	64.1	1,042	578
Total	\$1,263	*	\$1,576	\$951

*Percent totals do not add due to rounding.

^bWe estimate that 94.4 percent correctly reported their Form W-2 wages and wage deductions. At a 95-percent confidence level, this estimate could range from 93.0 percent at the lower limit to 95.8 percent at the upper limit.

Source: IRS' TCMP data.

In addition, we analyzed small corporations that filed calendar year tax returns. The small corporate TCMP sample of 18,138 tax returns included 6,316 returns filed for the calendar year. We further analyzed these 6,316 returns. We estimated that 5,152 of these small corporations deducted wages. We also estimated that 70.2 percent of all small corporations filed tax returns ending on a calendar year quarter, with a lower limit of 69.3 percent and an upper limit of 71.1 percent at the 95-percent confidence level.

Combining Estimates for Sole Proprietors and Small Corporations

We combined weighted statistical estimates for the subpopulations of sole proprietors and small corporations, using accepted statistical methodologies that apply when the size of the subpopulations is unknown. We estimated that sole proprietors and small corporations overstated all types of deductions on their tax returns by about \$40 billion, with a lower limit of \$38.7 billion and an upper limit of \$41.4 billion at the 95-percent confidence level.

Table I.8 shows the point estimates and statistical confidence intervals at the 95-percent confidence level for the overstated deductions we reviewed.

Table I.8: Point Estimates and Confidence Intervals on the Type and Amount of Overstated Deductions for Small Corporations and Sole Proprietors

Dollars in millions			
Payment type	Point estimate	Upper limit	Lower limit
Wages	\$3,214.7	\$3,702.2	\$2,727.3
Pensions	328.3	406.3	250.3
Rents	2,166.7	2,363.0	1,970.4
Interest	1,820.7	2,044.8	1,596.5
Services ^a	4,921.1	5,280.1	4,562.0
Bad debts	1,214.4	1,426.2	1,002.6
Total^b	\$13,665.9	\$14,377.4	\$12,954.4

^aServices include sole proprietor and small corporation tax deductions as stated in our estimates for tables I.1 and I.4.

^bPercent totals do not add due to rounding.

Source: IRS' TCMP data.

We also estimated that 10.5 million sole proprietors and small corporations claimed 1 or more of the 6 deductions we reviewed.¹ Of these small businesses, 4.5 million (42.9 percent) overstated at least 1 of the deductions, with a lower limit of 4.4 million and an upper limit of 4.7 million at a 95-percent confidence level.

Table I.9 shows the point estimates and statistical confidence intervals at the 95-percent confidence level for expenses not reported on information returns by small corporations and sole proprietors combined.

¹We estimated a lower limit of 10.3 million and an upper limit of 10.7 million.

**Appendix I
GAO Sampling and Data Analysis
Methodology**

Table I.9: Point Estimates and Confidence Intervals on Type and Amount of Expenses Not Reported as Required on Information Returns by Small Corporations and Sole Proprietors

Dollars in billions

Payment type	Point estimate	Upper limit	Lower limit
Wages ^a	\$4.8	\$5.6	\$4.1
Rents	5.4	6.0	4.8
Interest	.8	1.0	.6
Services	7.7	8.4	6.9
Total^b	\$18.8	\$20.0	\$17.5

^aWe could not estimate wages that sole proprietors failed to report on Forms W-2 because the data were not collected in the 1988 TCMP.

^bPercent totals do not add due to rounding.

Source: IRS' TCMP data.

Table I.10 shows the point estimates and statistical confidence intervals at the 95-percent confidence level for information filing requirements for small corporations and sole proprietors combined.

Table I.10: Point Estimates and Confidence Intervals of Information Filing Requirements for Small Corporations and Sole Proprietors With Rent, Service, and Interest Deductions

Type of expense/ filing status	Point estimate	Upper limit	Lower limit
Rent			
Required to file	837,617	876,196	799,039
Not required to file	3,427,899	3,543,377	3,312,402
Total^a	4,265,507	4,384,006	4,147,008
Services			
Required to file	1,876,179	1,934,245	1,818,112
Not required to file	6,761,843	6,968,087	6,555,600
Total^a	8,638,022	8,844,433	8,431,611
Interest			
Required to file	304,471	320,940	288,001
Not required to file	3,414,591	3,521,027	3,308,156
Total^a	3,719,062	3,825,539	3,612,585

^aTotals may not add due to rounding.

Source: IRS' TCMP data.

Judgmental Samples of TCMP Cases to Test the Feasibility of Reverse Matching

To determine the feasibility of reverse matching to identify overstated deductions and unfiled information returns, we judgmentally selected a sample of 189 TCMP tax returns filed by sole proprietors and small corporations. This sample covered all TCMP returns that met certain criteria at two IRS service centers. Results from analyzing this sample cannot be generalized to the nationwide populations of sole proprietors and small corporations.

We focused on overstated wage, rent, and pension deductions because we believed that considerable related data would be reported on information and other returns, including Forms 941 and 5500. We anticipated that an analysis of these deductions would provide the best opportunity to test the feasibility of reverse matching. By analyzing wage deductions, we found that commissions and cost of labor expenses often were paid to individuals other than employees and were reported as service payments on Forms 1099. Consequently, we added service deductions to our study.

For our analysis of wage, rent, and service deductions, we selected sole proprietor tax returns from the TCMP individual sample and corporate returns from the TCMP small corporation sample. For small corporations, we primarily selected calendar year returns but also included some returns with fiscal years ending on calendar year quarters in our wage deduction analysis. Our sample was limited to tax returns from the IRS Fresno, CA, and Ogden, UT, service centers. Within these sampling constraints, we selected all TCMP tax returns for which the deductions were overstated by at least \$1,000 based on the results of TCMP audits. Table I.11 shows the number of tax returns we requested and analyzed.

Table I.11: Number of TCMP Audits Requested and Analyzed by Type of Deduction and Business

Type of deduction and business	Returns requested	Returns analyzed	Returns not analyzed ^a
Wages			
Small corporation	87	42	45
Sole proprietor	49	31	18
Totals	136	73	63
Services^b			
Small corporation	7	7	0
Sole proprietor	40	31	9
Totals	47	38	9
Rent			
Small corporation	41	29	12
Sole proprietor	60	47	13
Totals	101	76	25

^aIRS was unable to provide these returns when we did our analysis.

^bIncludes commissions and cost of labor. Cost of labor may also include wages paid to employees.

Source: IRS' TCMP data.

For pension deductions, we identified all 69 TCMP small corporation cases in which TCMP examiners disallowed the entire tax deduction of at least \$100. Of these, we received and were able to analyze 12 TCMP cases in detail to determine the reason that pension expenses were disallowed.

To do our detailed analyses of wage, rent, service, and pension deductions, we matched related data from tax returns and from information and other returns. To match the data, we generally relied on data reported on information and other returns in TCMP audit files. For example, we used Form 941 return data in our analysis of overstated wage deductions because reliable Form 941 data were generally available in TCMP files and the amounts should be comparable to Form W-2 amounts. To determine whether all Form W-2 data were filed, we used IRS' analysis of required and filed amounts and other information in the audit files.

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