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United States General Accounting Office

Report to the Commissioner
Internal Revenue Service

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TAX ADMINISTRATION

IRS Can Improve Information Reporting for Original Issue Discount Bonds



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General Government Division

B-260162

March 15, 1996

The Honorable Margaret M. Richardson
Commissioner of Internal Revenue

Dear Ms. Richardson:

Information reporting is a vital tool for the Internal Revenue Service (IRS) in promoting voluntary compliance with our nation's income tax laws. This reporting, which is done through a series of information returns designed to report specific types of nonwage income on IRS Forms 1099, is intended to help ensure that taxpayers know of and report their investment and other income on their tax returns.

This report, which is based upon work we initiated under our basic authority, discusses IRS' efforts to ensure that information reporting occurs for investment income earned from bonds¹ sold at "original issue discount" (OID). Those efforts center on IRS Publication 1212, List of Original Issue Discount Instruments, which furnishes data for use in preparing Form 1099-OID information returns. Specifically, our objectives were to determine (1) whether Publication 1212 provides data on a complete list of existing OID bonds, (2) how IRS ensures that its list of OID bonds is complete, and (3) whether the publication's target audience relies on data from the publication to generate Forms 1099-OID.

Background

Generally, the term "OID" covers bonds sold at a discount, that is, below their redemption value. For example, an OID bond issue with a face value of \$100 million may be sold for \$60 million. The \$40 million difference is OID income. Taxpayers are to pay taxes on OID income as it accrues over a bond's life, even though they will not actually receive it until the bond matures or is sold.

Issuers of OID bonds and brokerage firms and banks that act as "middlemen"² for bond owners are responsible for determining the amount of OID income that accrues during a year and reporting it on Form 1099-OID

¹We use the term "bond" generically to designate various debt instruments offered to the public by private and public entities.

²Middlemen, such as brokerage firms and banks, hold the bonds in their roles as investment managers or as an accommodation to their customers to facilitate recordkeeping and subsequent transactions. In these cases, middlemen act as "street holders" of the bonds. Issuers regard street holders as the holders of record, or owners, and may be unaware of the true owners' identities. For that reason, the tax code requires middlemen to assume the information reporting responsibilities. Middlemen are Publication 1212's primary target audience.

to IRS and to certain bond owners, primarily individuals and partnerships. Because middlemen frequently lacked the information needed to do this reporting, IRS created Publication 1212. The publication, which is updated annually, has included a list of OID bonds by issuer name and, for each bond, data for use in determining OID income.

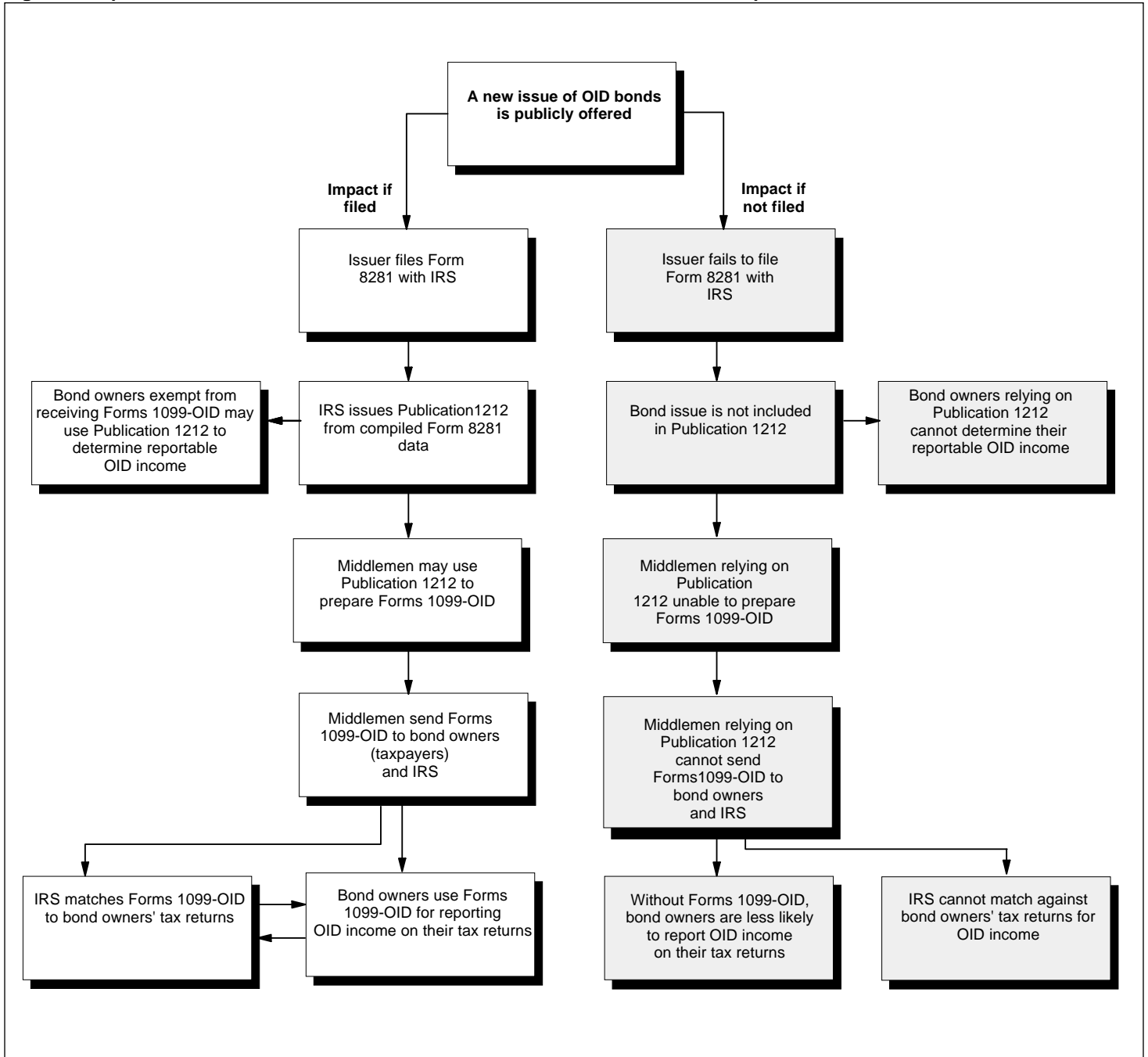
Bonds are to appear in Publication 1212 after bond issuers, primarily corporations, supply IRS with information by filing Form 8281.³ Issuers are required by law to report qualifying⁴ OID bonds to IRS within 30 days of issuance and face a penalty of up to \$50,000 for failing to do so on time.

Information reporting is one of only a few key means available to IRS to ensure that taxpayers fully report income on their tax returns, and Publication 1212 is IRS' primary tool for promoting information reporting on OID bonds. In this connection, figure 1 illustrates what will or may occur when the process for filing Form 8281 and Form 1099-OID works, or does not work, as IRS intended.

³Form 8281 is titled "Information Return for Publicly Offered Original Issue Discount Instruments."

⁴Appendix I discusses the categories of OID bonds that are not included in Publication 1212. Generally, Form 8281 does not have to be filed for bonds that fall into those categories.

Figure 1: Impact of Form 8281 and Form 1099-OID on Publication 1212 and Tax Compliance



Source: GAO analysis of information from Publication 1212 and IRS' information returns program.

Appendix I contains more information about the importance of information reporting;⁵ the requirements, procedures, and practices associated with Forms 8281 and 1099-OID; and the contents of Publication 1212.

Results in Brief

According to IRS, middlemen can rely on Publication 1212 to identify publicly offered OID bonds and to compute OID income for Form 1099-OID. However, many OID bonds are missing from Publication 1212, and IRS has done little to ensure that bond issuers file Form 8281, IRS' source of information for Publication 1212. Because many middlemen do rely on the publication to prepare Forms 1099-OID and it is incomplete, they may not be reporting all OID income to IRS or to bond owners.

Using several public information sources, we identified 37 OID bonds that should have been listed in the latest Publication 1212 but were not. Most of the 37 bonds were issued after 1990, with 28 issued in 1993 and 1994. If the 28 bonds had been included in Publication 1212, the number of bonds listed for 1993 and 1994 would have been 20 percent larger. The public information did not show every characteristic, such as the issuer's right to defer interest payments, that would identify an OID bond. For that reason, there may have been more bonds missing from Publication 1212 than we identified.

The 37 missing bonds we identified were issued with about \$10 billion in total OID, part of which would accrue as income to bond owners each year over the bonds' lives. We could not quantify how much tax revenue, if any, was lost as a result of accrued OID income from bonds not listed in Publication 1212 going unreported to owners and the IRS.

In some instances, information reporting may still have occurred through bond issuers rather than middlemen, or through middlemen large enough to use an OID information source other than Publication 1212. In other cases, information reporting of OID income may not have been required, such as when bonds were held in tax-exempt accounts or owned by corporations and certain other institutions that, according to the law, need not receive Forms 1099-OID. However, IRS encourages corporations owning OID bonds to use Publication 1212 to compute OID income. In any event, to meet IRS' intent of providing a source of information that middlemen can

⁵Over the years, we have supported the use of information returns to promote greater voluntary compliance by taxpayers and have recommended changes to make IRS' information and matching program more effective. Appendix II contains a list of products we have issued since 1982 that discussed information reporting for tax purposes.

rely on to prepare Forms 1099-OID, all publicly offered OID bonds should be listed in the publication.

The 37 bonds were not included in Publication 1212 because IRS had no record of receiving Forms 8281 from the issuers. There was no evidence that IRS was aware of the bond issues or took action to ensure that the forms were filed. Instead, IRS relied on the existence of the substantial penalty—up to \$50,000—to deter noncompliance. Although two IRS offices shared responsibility for issuing Publication 1212, no IRS office was directly responsible for making certain that Forms 8281 were filed in a timely manner or for imposing the penalty. IRS officials knew of no case when the penalty was ever imposed, either for nonfiling or for late filing.

Some members of two significant middlemen groups—the securities and banking industries—said they use other sources for identifying and computing OID income. However, industry representatives told us that many securities firms and banks, especially smaller ones, rely on Publication 1212 data to generate Forms 1099-OID. In addition, many of the securities and banking industry representatives we spoke with said that Publication 1212 serves a continuing need for OID data by providing a single, authoritative source of OID information.

Objectives, Scope, and Methodology

Our primary objectives on this self-initiated assignment were to determine (1) whether the list of OID bonds in Publication 1212 is complete, (2) how IRS ensures that it is receiving Forms 8281 on new OID bond issues, and (3) whether middlemen rely on Publication 1212 data to compute and report OID income on Forms 1099-OID. The latest edition of Publication 1212 at the time of our review was revised as of November 1994 and it contained several listings. We focused solely on section I-B of the 1994 edition, which lists the OID bonds issued after 1984 that are covered by the Forms 8281 filed by issuers.⁶

To determine the completeness of the listing of OID bonds in Publication 1212, we reviewed publicly available information such as Moody's Bond Record and Investment Dealers Digest to identify OID bonds and then determine whether these bonds were included in Publication 1212. Because the sources we used did not contain detailed characteristics of

⁶There were nine other listings in Publication 1212 covering corporate bonds issued before 1985, U.S. Treasury stripped bonds, and various types of short-term federal bonds. With stripped bonds, the right to receive interest payments and the right to receive principal values at maturity are sold separately. None of the nine listings were based on the tax code requirement that OID issuers inform IRS of new OID issues. They, therefore, were outside the scope of this assignment.

the bond issuances, we were only able to identify bonds as having OID if they were described as discount issues or if they were initially offered for significantly less than their face value. We were unable to look for other characteristics, such as deferred interest payments, that may have generated OID income in other bonds. At our request, IRS' Office of Chief Counsel reviewed the bonds we identified as eligible for inclusion in Publication 1212 to verify that they were issued with OID, the issuance had not been reported to IRS as required, and the bonds were not included in the November 1994 edition.

To determine how IRS ensures it is receiving Forms 8281 on new OID bond issues, we

- held discussions with officials of the Office of Chief Counsel, the Forms and Publications Division, and other IRS offices to obtain information on the processes IRS uses to obtain data for Publication 1212 and on how it enforces Form 8281 filing requirements;
- visited IRS' Detroit Computing Center, where Forms 8281 are initially processed, to ascertain the center's responsibilities in the reporting and enforcement process;
- spoke with the contractor that maintains IRS' Form 8281 database to ascertain its duties and responsibilities; and
- analyzed all readily available Forms 8281 filed with IRS since 1985 to determine total OID dollars for the bonds listed in Publication 1212 and the timeliness of form filings.

To determine whether middlemen relied on Publication 1212 data to generate Forms 1099-OID, we held discussions with representatives of financial service companies and securities, banking, and mutual fund trade associations and firms to obtain insight on the use they made of the publication. We obtained information from or through 3 financial service companies, 20 securities firms, 9 banks, the American Bankers Association (ABA), and the Securities Industry Association (SIA). We also interviewed other OID experts in the accounting and legal communities to obtain their perspectives on OID taxation and reporting and the market for OID bonds.

We identified the associations, financial service companies, and individual experts through discussions with IRS officials and others and our review of relevant literature. The securities firms we contacted were SIA members and judgmentally selected to include various types and sizes of firms. The banks we obtained information from were members of the ABA Tax Committee and were surveyed through the ABA, or were referred to us by

the Chairman of IRS' Information Reporting Advisory Committee or by a private information reporting consultant. We identified the OID legal and accounting experts through discussions with IRS officials and our review of relevant literature.

We did our work in Chicago, Detroit, and Washington, D.C., from September 1994 through July 1995 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from you or your designee. On January 23, 1996, we met with IRS National Office officials to obtain their comments on a draft of this report. IRS representatives at that meeting included the National Director for Service Center Compliance and the National Director of the Tax Forms and Publications Division. Their comments are summarized on pages 16-17 and incorporated into this report where appropriate.

Publication 1212 Was Incomplete as a Source for Preparing Forms 1099-OID

According to both the regulations covering Publication 1212 and the publication itself, middlemen can rely on the publication to determine whether a publicly offered bond was issued at a discount and, if so, the amount of OID income to be reported. Further, according to IRS, middlemen can avoid penalties for incomplete or inaccurate information reporting by relying on information in Publication 1212. IRS' statements of reliance imply that the publication's list of OID bonds is complete. However, we found it to be incomplete because it was missing many bonds.

Using publicly available information in sources such as Moody's Bond Record, we found 37 OID bonds that should have been listed in the November 1994 edition of Publication 1212 but were not. The bonds were not included because IRS had no record that the issuers had filed Forms 8281. Attorneys from IRS' Office of Chief Counsel reviewed this information and saw no reason why the issuers should not have filed Forms 8281.

Most of the 37 bonds were issued after 1990, although some dated back to 1985. Twenty-eight were issued in 1993 through 1994. If the excluded bonds were added to those already listed in Publication 1212, the number of bonds in the 1994 edition would increase by

- 8 percent for bonds listed as issued after 1985, and
- 20 percent for bonds listed as issued in 1993 through 1994.

Why the percentage increased for 1993 through 1994 was unknown.

The 37 bonds were issued with about \$10 billion of OID. For tax purposes, the OID should be recognized as income over the lives of the bonds, which was up to 20 years for some. To put this \$10 billion into better perspective, the 464 bonds in Publication 1212 for which data were available were issued with about \$40 billion in OID. The 28 bonds issued in 1993 through 1994 that should have been included in Publication 1212 were issued with \$7.1 billion of OID. In comparison, the 145 bonds added to the publication for those years were issued with \$9.1 billion of OID.

We could not determine how much tax revenue, if any, was lost because accrued OID income from bonds not listed in Publication 1212 might have gone unreported to owners and IRS. In part, this is because information reporting would be unnecessary on some portion of the \$10 billion when bonds were held in tax-exempt accounts or owned by tax-exempt organizations, corporations, and other institutions that are not required to receive information returns. Even so, bonds are not excludable from the publication merely because some eventual owners may not need to receive information returns. In its Publication 1212, IRS encourages owners of publicly offered OID bonds who do not receive Forms 1099-OID to use the publication to determine the amount of OID to report on their income tax returns.

Although we could not estimate the amount of tax revenue, if any, that may have been lost, there is evidence to suggest that loss of tax revenue can occur when a Form 1099-OID is not provided. In an earlier report on income resulting from the cancellation of indebtedness, we found that information returns increased taxpayer reporting of such income from less than 1 percent of income to almost 50 percent.⁷ This result underscores the importance of information reporting when the taxpayer may be unaware that taxable income has been received or recognized, as in the case of OID income. Although cancellation of indebtedness income differs significantly from OID income, the two types of income are similar in that they are taxable even though the taxpayer does not receive cash in the tax year. Clearly, by requiring information reporting for OID, Congress saw the need for taxpayers and IRS to be informed of accrued but unreceived OID income.

More bonds may have been missing from Publication 1212 than the 37 we found. Various features of a bond, such as deferred interest payments, can give rise to OID. The sources we reviewed allowed us to look for some of

⁷Tax Administration: Information Returns Can Improve Reporting of Forgiven Debts (GAO/GGD-93-42, Feb. 17, 1993).

these features but not all. Also, representatives of a service company that maintains its own OID database and prepares information returns for middlemen estimated that the company's database contained more than 150 OID bonds that Publication 1212 should have included but did not. The bonds in this database included a few predating the 1985 issuance notification requirement.

IRS Lacked an Effective Process for Identifying Nonfiling of Form 8281 and Ensuring Publication 1212 Was Complete

The tax code and related regulations require issuers to inform IRS within 30 days after they publicly issue OID bonds and subject them to a penalty of up to \$50,000 for not doing so. According to IRS Chief Counsel officials, IRS generally relied on the existence of the sizable penalty to ensure reporting compliance and, therefore, presumed that Publication 1212 was substantially complete. In our opinion, such reliance might be appropriate if the penalty were enforced. However, we found no IRS organization with primary responsibility for monitoring issuers' compliance and assessing the penalty, and no evidence that IRS had ever assessed the penalty. In addition, IRS did not take advantage of other information it received that could help it identify unreported OID offerings to make the publication more complete.

No IRS Organization Was Assigned Primary Responsibility for Monitoring Compliance

When the reporting requirement was placed on bond issuers in 1984, IRS officials discussed which part of the organization would have responsibility for (1) developing and maintaining Publication 1212, (2) monitoring Form 8281 filings from issuers, and (3) assessing penalties for noncompliance. Although IRS delegated responsibility for developing and maintaining Publication 1212 to the Forms and Publications Division, we found no evidence that it ever determined which office would monitor filings and assess penalties. IRS auditors have general responsibility for making certain that corporations under audit have filed all required forms, including Form 8281. However, as discussed more fully below, audits are more likely to occur long after a Form 8281 is due and auditors have not always identified a taxpayer's (issuer's) failure to file the form.

According to officials of the two offices responsible for developing and issuing Publication 1212—the Forms and Publications Division and the Office of the Chief Counsel—neither office had authority to assess the penalty. Similarly, officials at the Detroit Computing Center responsible for processing Forms 8281 were unaware of the penalty when we brought it to their attention and did not believe they had authority to assess it. Finally, the Office of Financial Products and Transactions, which was

established in March 1994 to, among other tasks, identify and develop strategies for addressing tax issues related to financial products, did not routinely receive information necessary to monitor Form 8281 filing compliance.

IRS auditors have the only documented responsibility (Internal Revenue Manual, section 4034.5) for determining whether OID bond issuers have filed required Forms 8281 and for imposing the penalty if they have not done so. As part of a standard check when auditing corporate taxpayers, auditors are to determine whether all applicable tax and information returns have been filed, including Form 8281. If a corporation does not file Form 8281 within 30 days of issuing publicly offered OID bonds and lacks reasonable cause for not filing the form, auditors are responsible for obtaining a completed form and imposing the nonfiling penalty. However, the audits are generally initiated at least a year after the returns are filed. In addition, IRS does not audit the majority of the almost 47,000 large corporations that are most likely to be issuers of publicly offered OID debt, those with assets of over \$10 million. IRS does audit most of the 1,700 largest corporations, those in its Coordinated Examination Program.⁸

IRS had no record of Forms 8281 being filed for the 37 bonds we found missing from Publication 1212. The bonds were issued by 34 corporations. Of these, 3 had issued other bonds that were listed in Publication 1212; the other 31 had not. The total OID income payable over the lives of these 37 bonds ranged from \$27.1 million for one bond to \$1.5 billion for another.

We asked the IRS Examination Division to determine whether any of the 34 issuers had been audited for the year of bond issuance and, if so, whether the audit identified a failure to file Form 8281. According to the Examination Division, of the 34 issuers,

- two issuers had been audited, but IRS had neither identified nor addressed their apparent failure to file Form 8281;
- one issuer was under audit, but the firm's apparent failure to file Form 8281 had not been identified; and
- two other issuers were under audit, and because we brought the matter to IRS' attention, IRS planned to determine whether each was responsible for filing Form 8281.

⁸See Tax Administration: Audit Trends and Taxes Assessed on Large Corporations (GAO/GGD-96-6, Oct. 13, 1995).

This lack of checking by auditors for required submissions was an issue that we discussed in 1989. At that time, we said IRS had missed identifying businesses that failed to file required information returns in about 50 percent of the 932 business return audits we reviewed.⁹

As a result of our review, IRS auditing officials were going to determine whether there were reasonable causes for the corporations not filing the 37 Forms 8281. As of August 1995, IRS had not resolved any of the 37 cases. However, as a result of our review, the Assistant IRS Commissioner for Examination issued a memorandum reminding audit staff of the Form 8281 filing requirement and reemphasizing the need to check for filing compliance when auditing corporate taxpayers. A reminder was also included in an internal newsletter that was to be sent to auditors who audit the largest corporations. In addition, IRS' Financial Products and Transaction Office included training on Form 8281 requirements as part of its continuing education program for its auditors. Financial Products and Transactions staff are generally responsible for addressing OID and other financial product issues during corporate audits. Finally, the Director of the Office of Financial Products and Transactions said that IRS needed to improve the completeness of Publication 1212, and said that it would be productive to match OID bonds listed in Publication 1212 with those contained in financial databases maintained outside of IRS.

Late Filing of Forms 8281 Did Not Result in Penalties

In addition to not identifying and penalizing Forms 8281 nonfiling, IRS did not consider imposing penalties when filings were late, sometimes seriously so. We reviewed the filing dates of 460 Forms 8281 filed between 1985 and 1994 and listed in the November 1994 Publication 1212. Of the 460 forms, 108 (23 percent) were filed from 12 to 816 days after the 30-day deadline, with an average delinquency of about 180 days. We also found six forms, with about \$488 million in total OID, that were not listed in the publication because they were filed too late.¹⁰ IRS could provide no evidence that it had attempted to determine whether a penalty was warranted in any of the 114 cases.

Thirty-three of the 108 issuers that filed late Forms 8281 included with their filings explanations of why they were late. The most common reason

⁹Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected (GAO/GGD-89-110, Sept. 8, 1989).

¹⁰These six Forms 8281 were filed more than 30 days after the bonds were offered and reached IRS after IRS' cutoff date for inclusion in the 1994 edition.

given was that the company was unaware of the filing requirement. Other reasons were inadvertent oversight and confusion between the company and its attorneys over who would file the form.

Form 8281 Penalty Was Not in IRS' Penalty Handbook

The issuance reporting requirement and related penalty were not addressed in IRS' Penalty Handbook, a reference tool for IRS employees who impose and assess penalties. The handbook, which was issued in 1992, is intended to encompass all civil penalties. According to an IRS official, the Form 8281 penalty was omitted from the 1992 issuance because it was of lesser priority. IRS planned to add the penalty to the handbook in fiscal year 1996 as part of a chapter on miscellaneous penalties.

IRS Did Not Use Other Means to Obtain Compliance

IRS receives other information that it could use to help ensure that OID issuers file Forms 8281. The corporate tax return, Form 1120, asks taxpayers to mark a checkbox if they issued any publicly offered OID debt during the fiscal year and reminds corporations of their responsibility to file Form 8281 when OID debt is issued. A mark in the checkbox would not necessarily mean that a Form 8281 had to be filed because, as discussed in appendix I, some publicly offered OID bonds do not require the filing of a Form 8281. However, a checkmark would provide a lead that IRS could pursue. IRS did not attempt to use this information to identify potentially missing Forms 8281. Historical information was not available on the reasons for placing the checkbox on the corporate tax return and its intended use.

Form 1099-OID also provides a potential cross-check on whether Forms 8281 are filed. Middlemen that rely on commercially available OID databases can generate Forms 1099-OID for bonds in those databases that may be missing from Publication 1212. Form 1099-OID contains the same bond CUSIP¹¹ number as Form 8281 does. However, IRS cannot readily compare the CUSIP numbers by computer because the number is not easily located on Form 1099-OID. That is, it can be anywhere within a section of the form that describes the bond. IRS had no plans to revise the form to make extraction of the CUSIP number easier.

¹¹The CUSIP is the ABA's Committee on Uniform Security Identification Procedures, and it assigns identification numbers to security issues.

Middlemen's Reliance on Publication 1212 May Result in OID Underreporting

Because Publication 1212 is incomplete, middlemen relying on its information to meet their OID information reporting requirements may not be reporting on all OID bonds they hold for their customers. Bond holders, consequently, may not report such income on their tax returns. According to information provided by members of the securities and banking communities, many securities firms and banks, especially the smaller ones that make up the greatest number in both industries, rely on information in Publication 1212 to fulfill their Form 1099-OID reporting responsibilities. Many of those we interviewed said that the issuance of OID bonds will increase in the foreseeable future.

Securities Industry Reliance on Publication 1212

According to SIA representatives,¹² small- and medium-sized securities firms who frequently act as middlemen for bond owners substantially relied on Publication 1212 to prepare their information returns. These firms, the representatives said, make up a relatively large proportion of the thousands of existing securities firms, and they probably cannot afford to use the commercial services for information reporting that major securities firms generally use.

Of the 20 mostly large securities firms we contacted, 3 said that they either used Publication 1212 directly or relied on commercial services that used it to prepare information returns. The remaining 17 firms relied on commercial firms that had developed or bought OID databases to assist in information reporting. Their reasons for doing so varied but included the perception that Publication 1212 was incomplete, the need for assistance in calculating OID accruals and processing Forms 1099-OID, and the need for information that was beyond the publication's scope. However, as discussed below, the majority of these firms said Publication 1212 was useful for other purposes.

The representatives of the SIA and securities firms we interviewed could offer no definitive reasons why issuers might not file Form 8281. Some speculated that because they lacked knowledge of the filing requirement, smaller regional firms or firms using a new investment banker might fail to file the form. Others said that the more unusual or complex OID issues were the ones missing from Publication 1212.

¹²According to an SIA representative, the 700+ SIA member firms account for more than 90 percent of the U.S. securities industry's revenue.

Banks' Reliance on Publication 1212

As we learned from nine banks—five that the ABA surveyed for us and four that we contacted directly—banks' reliance on Publication 1212 to identify OID bonds and determine OID income varied. Three of the five banks surveyed by ABA said they used Publication 1212, either directly or through an information reporting service. The other two used a source other than the publication. Two of the four large banks we contacted relied primarily on Publication 1212 to identify and calculate OID on bonds for information reporting, and two relied on commercial firms.

According to an information reporting consultant working with small banks, many small banks use Publication 1212 to identify OID instruments and determine the amount of OID to report. Small banks, the consultant said, generally cannot afford to use commercial services to identify OID bonds or to prepare their information returns.

Publication 1212 Continues to Serve a Need

Representatives of the organizations we interviewed saw a continuing need for Publication 1212. According to representatives of one of the large service firms, Publication 1212 was the anchor of the OID information reporting process and, without it, OID reporting would result in a “wild west” situation, with no single reliable information source. According to representatives of this firm and the SIA, without Publication 1212, reporting compliance would decrease and OID information reported would become more inconsistent.

The securities firms and banks we contacted generally supported the need for Publication 1212. Their reasons included

- the authoritativeness of the publication due to the safe harbor provisions¹³ of the Department of the Treasury's information reporting regulations,
- the need for a reference source with which to address their questions or their customers' questions, and
- the importance of having a source that they and their customers could use to verify the accuracy of OID income data that service companies provided.

Publication 1212 is important in helping ensure proper corporate reporting of OID income. Corporate bond holders are encouraged by IRS to use the publication to calculate OID income. SIA representatives told us that most corporate taxpayers do not receive Forms 1099-OID or equivalent information and, therefore, have to rely on Publication 1212 to determine

¹³These provisions mean that middlemen relying on Publication 1212 cannot be penalized by IRS due to faults of the publication.

their reportable OID income. In addition, IRS auditors use Publication 1212 to ensure that corporations' OID income is properly reported.

Finally, many of the individuals we interviewed from service companies and the banking and securities industries expected that the number of OID issues will increase as new types of debt instruments appear. Also, representatives of IRS' Office of Chief Counsel said finalization of the contingent debt regulations may increase Form 8281 filings for these instruments.¹⁴

Middlemen's continuing reliance on Publication 1212 and the anticipated increase in the issuance of OID bonds heighten the importance of Publication 1212 as a complete and accurate data source for information reporting. Without a complete and accurate publication, IRS and middlemen cannot be assured that all OID income has been reported. Incomplete reporting may result in taxpayers understating their income and the resulting tax liability.

Conclusions

IRS created Publication 1212 to promote information reporting of OID income and to generate greater voluntary compliance on the part of taxpayers. Information reporting is especially important for OID income because this type of income is accrued and, therefore, not as visible to taxpayers as other forms of income. It is also important to IRS because IRS has few other means available to make certain that taxpayers report OID income on their tax returns.

Although IRS has continued to issue the publication, it has done little to ensure that the publication contained information on all the appropriate OID bonds. It did not monitor and enforce Form 8281 filing requirements. Although discussions occurred in the mid-1980s, we found no IRS organization that had been assigned the responsibility for monitoring and ensuring timely Form 8281 filing, such as ensuring that bond issuers were generally aware of the filing requirement or assessing penalties when IRS became aware that taxpayers had not filed Forms 8281 on time. As a result, we found that the publication was missing many bonds issued with billions of dollars of OID, and middlemen's information reporting was very likely not as comprehensive as it could have been.

¹⁴Contingent debt instruments are those whose redemption values depend on the market value of some other security or security index. Under IRS' proposed regulations, all such debt instruments would be considered as issued with OID.

According to middlemen and securities industry representatives we contacted, many middlemen rely on Publication 1212 information to meet their OID information reporting requirements. However, as long as IRS does not ensure that the publication is complete, the publication's value will be lessened, both to middlemen that must provide information reports and to IRS in its efforts to improve voluntary compliance.

Recommendations to the Commissioner of Internal Revenue

To help IRS better meet its responsibility to provide middlemen with complete and reliable information that can be used for OID information reporting, and to help better ensure that the billions of dollars of OID income are properly reported for tax purposes, we recommend that you

- assign organizational responsibility for monitoring and enforcing the OID bond issuance reporting requirement to specific organizational units and establish formal linkages between the units so that each can effectively carry out its responsibilities;
- develop procedures, such as periodically matching the list of OID bonds in Publication 1212 with those contained in databases outside of IRS, to improve and help ensure the completeness and reliability of Publication 1212 as an authoritative source of OID information for middlemen; and
- work with representatives of the securities industry to develop a means to inform and remind OID bond issuers of their responsibility to file Forms 8281.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from you or your designated representative. We met with your designated representatives, including the National Director for Service Center Compliance and the National Director of the Tax Forms and Publications Division, on January 23, 1996, to receive and discuss IRS' comments. They said the report was comprehensive and agreed with the intent of all three proposed recommendations. The officials also said the draft report was generally accurate except for some clarifications, which we incorporated in this report where appropriate.

We modified one of the recommendations that we proposed in the draft report so that we no longer recommend that monitoring and enforcement responsibilities should be assigned to "a specific organizational unit." Although IRS officials agreed that monitoring and enforcement of Form 8281 filings should be improved, they said monitoring should be assigned to one IRS function and enforcement to another, in keeping with IRS'

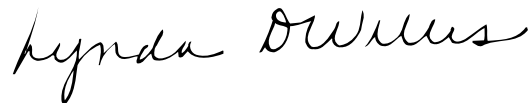
traditional operating structure. They also agreed that formal linkages between functions should be established so that when one identifies problems the other would be made aware. We revised our final recommendation to (1) acknowledge IRS' policy of separating monitoring and enforcement responsibilities and (2) call for the establishment of formal linkages between the monitoring and enforcement units.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight not later than 60 days after the date of this letter. A written statement must also be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this letter.

We are sending copies of this report to various congressional committees, the Secretary of the Treasury, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others on request.

The major contributors to this report are listed in appendix III. If you have any questions about this report please call me on (202) 512-9110.

Sincerely yours,



Lynda D. Willis
Director, Tax Policy
and Administration Issues

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Abbreviations

| | |
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| ABA | American Bankers Association |
| CUSIP | Committee on Uniform Security Identification Procedures |
| IRS | Internal Revenue Service |
| OID | Original Issue Discount |
| SIA | Securities Industry Association |

Information on the Importance of Information Returns, Contents of Publication 1212, and Requirements and Practices Associated With Forms 8281 and 1099-OID

Information reporting is one of only a few key means available to IRS to ensure that taxpayers fully report income on their tax returns. Over the last 15 years or so, IRS' audit coverage has dropped substantially. During that period, however, expanded information-reporting requirements and IRS' use of that information has allowed IRS to increase its checks for unreported income in a more cost-effective manner.

For some financial products,¹ IRS depends on receiving information returns—Forms 1099—for income data that it matches against corresponding data on tax returns. We have supported the use of information returns to promote greater voluntary compliance and have recommended changes in IRS' information reporting and matching program to make it more effective. (See app. II for a list of related reports.)

Publication 1212 is IRS' primary tool for ensuring complete information reporting on OID bonds. The OID bonds that appear in Publication 1212 are limited to publicly offered, long-term (more than 1 year) issues that accrue more OID income than “de-minimis” amounts (.25 percent annually). They are issued by corporations, government, and quasi-government entities (such as the Federal Farm Credit Bank and the Student Loan Marketing Association) and cover a broad range of complexity, from the relatively simple to the very complicated. According to the November 1994 edition of Publication 1212, OID bonds to be included cannot be

- long-term OID instruments issued before May 28, 1969;
- original issue U.S. Treasury notes and bonds;
- U.S. savings bonds;
- debt instruments issued at a discount by states or their political subdivisions;
- mortgage-backed securities and mortgage participation certificates;
- real estate mortgage investment conduits with regular interest and collateral debt obligations;
- commercial paper and banker's acceptances that may have been originally issued at a discount;
- obligations issued by tax-exempt organizations;
- obligations issued at a discount by individuals;
- certificates of deposit and other face amount certificates issued at a discount, including syndicated certificates of deposit; and,
- foreign obligations not traded in the United States and obligations not issued in the United States.

¹As discussed in our letter, *Options Reporting to IRS* (GAO/GGD-95-145R, May 5, 1995), options transactions are not subject to annual information reporting requirements.

Appendix I
Information on the Importance of
Information Returns, Contents of Publication
1212, and Requirements and Practices
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Publication 1212 is to be updated annually and is to be used to prepare tax returns for a specific year. For example, at the time of our review, the latest publication was revised as of November 1994 and was to be used in preparing 1994 tax returns. It included a list of OID bonds by issuer name and, for each bond, data for use in determining the OID income to be reported. These data included the amount of OID accruing per \$1,000 of maturity value on a daily and annual basis for 1994 and 1995.

Under the Internal Revenue Code and related regulations, issuers of OID bonds, or the brokers and other middlemen that hold them for bond owners, are responsible for annually reporting to certain owners—primarily individuals and partnerships—and IRS the income that accrued or was paid.² They are to report this information using a paper or computerized IRS Form 1099-OID. Annual information returns are not required for OID income earned by tax-exempt organizations or certain taxable entities such as corporations and financial institutions. Nonetheless, taxable entities are responsible for reporting and paying appropriate taxes on OID income.

When the Form 1099-OID reporting requirement was first placed on middlemen in the early 1980s, middlemen said they had no practical source of information with which to meet the requirement. For example, they said that although they might obtain the necessary data from the issuer's prospectus statement for each bond, the effort could be burdensome. Responding to the securities industry's requests for a practical source of information, IRS agreed to publish Publication 1212, which it first did in 1983.

The Internal Revenue Code and related regulations require issuers of OID bonds, except for those noted above, to tell IRS when the bonds are first publicly offered to buyers. This mandatory requirement was established to ensure that information would be obtained on the 300 to 400 new issues expected each year. Reporting is to occur within 30 days of issuance, and issuers who willfully report late or not at all are subject to a penalty of 1 percent of the issue price, up to a maximum of \$50,000.

²Congress began requiring the annual accrual and information reporting of OID income in 1969 in order to preclude taxpayers' deferral of the income or their reporting of it as capital gains rather than ordinary income. Then, as now, capital gains were subject to preferential tax rates. Over the years, Congress has included more types of instruments under the accrual and reporting requirements, and in 1982, it gave IRS the authority to impose the reporting requirement on middlemen.

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To inform IRS of a new OID bond, issuers are to send IRS Form 8281 to the Detroit Computing Center. After the Center performs some clerical processing, a company under contract with IRS analyzes the forms and accompanying information to decide which bond issues fit the criteria for inclusion in Publication 1212 and follows up with the issuers as needed. Using a computerized file of Form 8281 data, the contractor also determines the OID income-accrual rates that are to appear in Publication 1212. The contractor has no responsibility for identifying OID bonds that have not been reported to IRS on Form 8281 and including them in Publication 1212.

The November 1994 edition of Publication 1212 included about 780 long-term OID bonds, including 478 issued since 1985. According to IRS' files, 464 of the 478 bond issues were issued with about \$40 billion of OID. Information on the remaining 14 issues was not readily available from the files.

Since IRS began issuing Publication 1212, some brokerage and financial service companies have developed proprietary databases of OID debt issues for use in preparing Forms 1099-OID (1) for their own customer accounts or (2) as a paid-for service to middlemen. These brokerage and service companies may also sell their databases to middlemen or other financial service companies for their use in preparing information returns. We did not determine how every firm built its database, but two of the largest firms (a brokerage firm and a service company) said they used financial market reporting services, Securities and Exchange Commission filings, and Publication 1212.

GAO Products Issued Since 1982 That Discussed Information Reporting for Tax Purposes

Tax Administration: Information Returns Should Increase Proper Reporting of Farm Income (GAO/GGD-86-69, July 22, 1986).

The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, Mar. 17, 1987).

Tax Administration: IRS' Efforts to Establish a Business Information Returns Program (GAO/GGD-88-102, July 22, 1988).

Tax Administration: State and Local Compliance With IRS' Information Reporting Requirements (GAO/GGD-89-63, May 4, 1989).

Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected (GAO/GGD-89-110, Sept. 8, 1989).

Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 25, 1989).

Tax Administration: Status of IRS' Test of a Business Information Returns Program (GAO/GGD-90-38, May 29, 1990).

Information Returns: Correcting Taxpayer Identification is Possible Without Disclosing Tax Data (GAO/GGD-90-90, June 5, 1990).

Tax Policy and Administration: IRS' Compliance Programs to Reduce the Tax Gap (GAO/T-GGD-91-11, Mar. 13, 1991).

Tax Administration: IRS Can Improve Its Program to Find Taxpayers Who Underreport Their Income (GAO/GGD-91-49, Mar. 13, 1991).

Tax Administration: Expanded Reporting on Seller-Financed Mortgages Can Spur Tax Compliance (GAO/GGD-91-38, Mar. 29, 1991).

Tax Policy and Administration: IRS' Efforts to Ensure Corporate Tax Compliance (GAO/T-GGD-91-21, Apr. 17, 1991).

Tax Policy: Refund Offset Program Benefits Appear to Exceed Costs (GAO/GGD-91-64, May 14, 1991).

IRS Needs to Implement a Corporate Document Matching Program (GAO/T-GGD-91-40, June 10, 1991).

Appendix II
GAO Products Issued Since 1982 That
Discussed Information Reporting for Tax
Purposes

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

Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations (GAO/GGD-92-130, Sept 22, 1992).

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

Tax Administration: Computer Matching Could Identify Overstated Business Deductions (GAO/GGD-93-133, Aug. 13, 1993).

Tax Administration: Options Reporting to IRS (GAO/GGD-95-145R, May 5, 1995).

Major Contributors to This Report

General Government Division, Washington, D.C.

Michael Brostek, Assistant Director
Jose Oyola, Assistant Director
Mary Phillips, Assignment Manager
Anthony Assia, Senior Evaluator
Robert Floren, Evaluator

Chicago Field Office

Thomas Venezia, Core Group Manager
Neal Gottlieb, Evaluator-in-Charge
Donald Kittler, Senior Evaluator

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