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INTERNAL REVENUE SERVICE

Changes to IRS's Schedule K-1 Document Matching Program Burdened Compliant Taxpayers

GAO Accountability•Integrity•Reliability

Highlights

Highlights of GAO-03-667, a report to the Committee on Business and Entrepreneurship, United States Senate

Why GAO Did This Study

About $1 trillion in income was distributed in 2001 by flow-through entities such as partnerships and trusts. As shown below, these entities do not pay taxes on flow-through income. They report it to IRS on a Schedule K-1 and their partners or beneficiaries pay any tax.

Concerned about underreporting, IRS began matching the flow-through income reported on Schedule K-1s with that reported on individuals' returns. In 2002, IRS began sending notices to taxpayers about suspected noncompliance. After complaints that many notices were going to compliant taxpayers, IRS stopped sending notices.

Concerned about the burden, the committee asked GAO to, among other things, (1) describe the burden caused by the notices and IRS's rationale for stopping them, (2) assess IRS's management of the program, and (3) describe the steps IRS will take to address any problems.

What GAO Recommends

GAO is not making any recommendations, but the uncertainty about the effectiveness of the steps IRS is taking to improve the program highlight the importance of IRS continuing to monitor the impact of the program on compliant taxpayers. In ongoing work, requested by the Senate Committee on Finance, GAO is assessing the effectiveness of the program.

www.gao.gov/cgi-bin/getrpt?GAO-03-667.

To view the full report, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

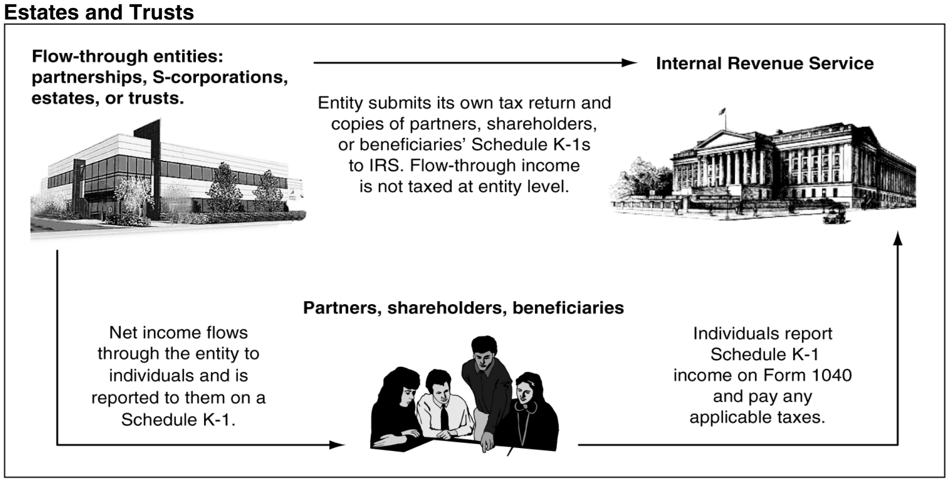
What GAO Found

IRS stopped issuing Schedule K-1 notices after complaints about the burden the program imposed on compliant taxpayers. Originally, IRS intended to focus the program on two categories of income--interest and dividends--wherein matching was straightforward, and therefore the number of notices sent to compliant taxpayers could be minimized. However IRS changed the matching program to cover additional categories of flow-through income without clearly informing taxpayers and tax preparers. Matching these additional categories of income was less straightforward. As a result, IRS sent notices about suspected noncompliance to more compliant taxpayers than it intended. In fact, about two-thirds of the notices were sent to taxpayers later determined to be compliant. After taxpayers complained, and after sending out about 70 percent of the planned notices, IRS responded by stopping the notices. IRS has assessed about $41.4 million in additional tax from the notices that were sent and approximately $26.9 million was directly attributable to Schedule K-1 underreporting.

IRS did not timely implement two parts of the plans for managing the Schedule K-1 matching program. First, IRS did not test the feasibility of focusing the program on interest and dividend income until after recommending such a focus and communicating the recommendation to taxpayers, preparers, and other stakeholders. Second, after changing the plan, IRS did not clearly communicate the changes.

IRS is taking steps to improve communications and reduce the burden on compliant taxpayers. However, neither IRS nor GAO knows whether these changes will improve communications and reduce burden while maintaining the effectiveness of the Schedule K-1 matching program as a compliance tool.

Illustration of the Taxation of Income That Flows Through Partnerships, S-corporation, Estates and Trusts



Source: GAO (images, Art Explosion).