

Highlights of [GAO-04-1040](#), a report to the Committee on Finance, U.S. Senate.

TAX ADMINISTRATION

IRS Should Take Steps to Improve the Accuracy of Schedule K-1 Data

Why GAO Did This Study

Over a trillion dollars in income was distributed in tax year 2002 by flow-through entities, such as partnerships, subchapter S corporations, and trusts, to their partners, shareholders, or beneficiaries, respectively. The Internal Revenue Service (IRS) estimates that from 6 to 15 percent of such income is unreported on individual tax returns. This income is reported to both IRS and to the recipients on a Schedule K-1 (K-1). IRS uses K-1 data in its document-matching program to identify noncompliance and for other purposes. GAO was asked to (1) assess the accuracy of K-1 data, specifically transcription errors and taxpayer identification numbers (TIN); (2) determine whether any limitations in the availability or accuracy of K-1 data have affected IRS's ability to identify noncompliance; and (3) identify the benefits and challenges of increasing e-filing of K-1s.

What GAO Recommends

To improve the availability and usefulness of K-1 data to IRS for detecting noncompliance, GAO recommends that IRS conduct a pilot study to determine the benefits and costs of obtaining corrected TINs from flow-through entities as soon as they are found to be invalid.

IRS agreed with our recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-04-1040.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

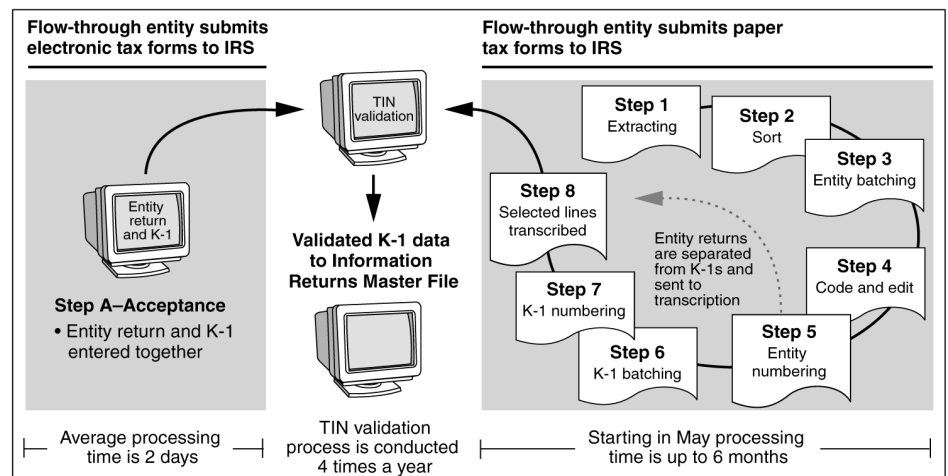
What GAO Found

The accuracy of paper-filed K-1 data is reduced by transcription errors; paper and e-filed K-1s have inaccurate TINs. IRS estimates that transcription errors for tax year 2002 ranged from 5 and 9.5 percent and is taking steps to address such errors. Although e-filed K-1s do not require transcription, for tax year 2002, the percentage of invalid TINs for e-filed K-1s and paper-filed K-1s were comparable (7 and 6 percent, respectively). Due to potential burden on flow-through entities and resource constraints, IRS does not notify the entities of invalid TINs on K-1s for correction. If IRS did so, this would likely give e-filing entities enough time to correct invalid TINs before IRS runs its document-matching program.

Inaccurate or limited K-1 data have created problems for IRS researchers and examiners. IRS research staff indicated that inaccurate TINs adversely affected their analysis of flow-through entity networks. Further, because IRS captures limited data from flow-through entity returns, including the K-1, IRS staff lack data they consider helpful, such as "Other Income" to help identify tax shelters. In at least 40 percent of closed examination cases we sampled, IRS examiners found errors with return line items not entered into IRS's databases when returns are received. If these lines were available up front, researchers say they would be able to better identify returns with potential noncompliance.

Increased e-filing of K-1s would provide benefits and challenges to both IRS and taxpayers. Benefits for IRS include faster, more complete information and millions in annual cost reductions. Benefits for taxpayers include fewer IRS contacts with them because IRS would have more accurate information in its systems. The primary challenge for IRS is its current inability to electronically process all flow-through entity returns and related forms, including the K-1. For taxpayers, the primary challenge is the cost of converting from paper to e-filing.

Paper K-1s: Lengthy Processing Yields Incomplete Data



Source: GAO analysis of IRS data.