

May 2011

INFORMATION
REPORTING

IRS Could Improve
Cost Basis and
Transaction
Settlement Reporting
Implementation



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Why GAO Did This Study

Effective implementation of two 2008 laws by the Internal Revenue Service (IRS) could increase taxpayers' voluntary compliance. Those laws require reporting to IRS and taxpayers of cost basis for sales of certain securities and of transaction settlement information (i.e., merchants' income from payment cards or third party networks).

In response to a congressional request, GAO (1) assessed IRS's implementation plans for the laws; (2) determined the extent to which IRS issued timely regulations and guidance and did outreach; (3) examined how IRS will use the new data to improve compliance; and (4) analyzed IRS's plans to assess implementation and measure performance and outcomes.

GAO compared IRS's implementation plans to criteria in past GAO work and other sources; interviewed industry groups and agency officials, and reviewed rulemaking documents; examined IRS's plans to use the new data; and compared IRS's measures and evaluation plans to GAO criteria.

What GAO Recommends

GAO recommends, among other things, that IRS improve cost estimation, form volume projections, stakeholder communication, and performance management. IRS generally agreed with the recommendations, but did not describe plans to release draft form instructions or communicate target guidance release dates, both of which would aid industry implementation.

View [GAO-11-557](#) or key components. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

INFORMATION REPORTING

IRS Could Improve Cost Basis and Transaction Settlement Reporting Implementation

What GAO Found

IRS is implementing cost basis and transaction settlement reporting through the new Information Reporting and Document Matching (IRDM) program in the Small Business/Self Employed (SB/SE) and Modernization and Information Technology Services (MITS) divisions. IRDM plans show several elements of effective program management, but do not document coordination with some related IRS projects such as *Workforce of Tomorrow*. IRS estimated IRDM costs, but MITS's estimate does not reflect some best practices, such as adjusting for inflation. Also, IRDM did not use substantiated tax form volume projections in some budget and risk decisions. To date, IRS spent about \$28 million on IRDM and requested another approximately \$82 million as shown below.

IRDM Actual and Requested Funding since Program Inception

Dollars in millions

Fiscal year	SB/SE IRDM actual or requested funds			MITS actual and requested funds	Total
	Cost basis reporting	Transaction settlement reporting	Other direct costs for both		
2009 through 2011, actual				\$51.0	\$51.0
2012 request	\$1.3	\$27.5	\$6.9	\$23.2	\$58.9
Total, 2009 through 2012					\$109.9

Source: Fiscal year 2012 budget request for IRS and IRDM budget documents.

Note: Other direct costs for both include handling appeals and litigating cases not resolved by audit or appeal.

IRS outreach with industry stakeholders was thorough early in the rulemaking process, but IRS missed its target dates for issuing regulations by about 1 year due, according to IRS officials, to time needed to learn the complex industries. After IRS released final regulations, industry stakeholders sought clarification of certain issues. IRS did not release additional written guidance until after the regulations' effective dates, which industry stakeholders said may affect their implementation of the new reporting requirements. Although IRS released drafts of the newly required or revised forms, they did not release draft instructions prior to the regulations' effective dates.

To use the new data, IRS is developing systems that are expected to improve IRS's existing matching of information returns to individual tax returns and expand matching to business taxpayers. The initial enhancements are to be operational in 2012. IRDM appropriately plans to conduct research and test data quality.

IRDM regularly documents lessons learned; however, IRDM has not assigned responsibility or established procedures to use them. IRDM also developed preliminary performance measures to assess the implementation and outcomes, including effects on revenue and compliance. However, IRDM has not documented a plan to finalize the performance measures, such as methodology.

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Abbreviations

AUR	Automated Underreporter
BMF	Business Master File
CADE	Customer Account Data Engine
CFO	Chief Financial Officer
DRIP	Dividend Reinvestment Plan
ETA	Electronic Transactions Association
FAQ	Frequently Asked Questions
FIF	Financial Information Forum
FIRE	Filing Information Returns Electronically
ICI	Investment Company Institute
IMF	Individual Master File
IPM	Integrated Production Model
IRDM	Information Reporting and Document Matching
IRMF	Information Returns Master File
IRPAC	Information Reporting Program Advisory Committee
IRS	Internal Revenue Service
IT	Information Technology
JCT	Joint Committee on Taxation
MTS	Modernization and Information Technology Services
RAS	Research Analysis and Statistics
RIC	Regulated Investment Company
PSE	Payment Settlement Entity
SB/SE	Small Business/Self Employed
SIFMA	Securities Industry and Financial Markets Association
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number

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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

May 19, 2011

The Honorable Max Baucus
Chairman
The Honorable Orrin G. Hatch
Ranking Member
Committee on Finance
United States Senate

The Honorable Charles E. Grassley
Ranking Member
Committee on the Judiciary
United States Senate

The nation's mounting \$14 trillion plus debt, as of May 2011, coupled with the \$345 billion gross tax gap—or the difference between what taxpayers should have paid and actually did—underscores the importance of the Internal Revenue Service's (IRS) efforts to ensure everyone meets their obligation to pay taxes.¹ Despite voluntary compliance on the part of most taxpayers and vigorous enforcement, about 16 percent of taxes are uncollected annually, according to IRS.

IRS seeks to increase voluntary compliance with tax laws, in part, by comparing—i.e., matching—income or expenses reported by third parties on information returns to those taxpayers report on their tax returns. To increase the information available to IRS for compliance purposes—and therefore increase the potential for raising revenue—Congress passed several acts in recent years requiring new third-party information reporting. Establishing an effective matching program is important not only for revenue collection, but also because the biggest benefit of information reporting is the increase in voluntary compliance that is expected to occur because taxpayers have the information they need to accurately report income and they realize that IRS has access to those data. One provision of one of the new laws requires brokers to report the adjusted cost basis for certain securities and identify whether a gain or loss is short- or long-term (referred to in this report as “cost basis

¹The debt figure is the total public debt outstanding. The gross tax gap was last estimated by IRS for tax year 2001. At that time, IRS estimated that it would eventually recover around \$55 billion of the 2001 tax gap through late payments and IRS enforcement actions, leaving a net tax gap of \$290 billion.

reporting”).² In 2008, the Joint Committee on Taxation (JCT) projected this provision to generate \$6.67 billion in revenue over 10 years. Another provision in the other law requires the reporting of merchants’ gross amount of income from payment card or third-party payment network transactions (referred to in this report as “transaction settlement reporting”).³ In 2008, the JCT projected this provision to generate \$9.8 billion in revenue over 10 years. In prior reports, we recommended that Congress consider cost basis reporting legislation and provided information to Congress on payment card reporting.⁴

Because IRS’s effective implementation of these laws could decrease the tax gap, you requested that we: (1) assess IRS’s implementation plans for the new reporting requirements, including its cost estimates; (2) determine the extent to which IRS communicated with industry stakeholders, issued timely regulations and guidance, and undertook outreach efforts to facilitate stakeholders’ ability to comply with the new reporting requirements; (3) examine how IRS will use the new returns to improve compliance and determine how implementation may affect its other functions and its ability to process and match other kinds of information returns; and (4) analyze IRS’s plans to assess the implementation process, develop performance measures to monitor operations, and determine any outcomes, such as the effects of the new returns on voluntary compliance.

To do our work, we analyzed IRS’s planning, implementation, and cost estimate documents to determine whether they met best practices established by IRS guidance, such as its *Internal Revenue Manual*, and in several prior GAO reports cited throughout this report. We also examined budgets, the new legislation, IRS’s proposed regulations, and public comments received, as well as information technology plans, preliminary performance measures, and associated plans for the new requirements. We interviewed IRS officials, including those who are a part of the Information Reporting and Document Matching (IRDM) program, the

²Energy Improvement and Extension Act of 2008, Pub. L. No. 110-343, div. B, § 403, 122 Stat. 3765, 3854-3860 (2008).

³Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, Housing Assistance Tax Act of 2008, div. C, § 3091, 122 Stat. 2654, 2908-2911 (2008).

⁴See GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, [GAO-06-603](#) (Washington, D.C.: June 13, 2006) and *Tax Administration: Costs and Uses of Third-Party Information Returns*, [GAO-08-266](#) (Washington, D.C.: Nov. 20, 2007).

group responsible for the laws' implementation. We also interviewed industry stakeholders, which represent groups required to file information returns under the new cost basis and transaction settlement provisions, as well as members of IRS's Information Return Program Advisory Committee.

We conducted this performance audit from June 2010 through May 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. See appendix I for more information on our scope and methodology.

Background

Cost Basis Reporting

IRS estimated, for tax year 2001, that \$11 billion of the tax gap could be attributed to individual taxpayers who misreport income from capital assets, such as securities and other assets owned for investment or personal purposes.⁵ Specific to securities transactions, we estimated based on IRS data and examination of case files, that for the same year, 38 percent of individual taxpayers misreported their capital gains or losses.⁶ To help prevent some taxpayer misreporting, brokers must, under the new requirements, report the adjusted cost basis for certain securities on a revised Form 1099-B, "Proceeds From Broker and Barter Exchange Transactions."⁷ For certain securities, brokers must begin collecting these data on January 1, 2011, and report them to IRS in 2012. Brokers must

⁵The overall capital gains tax gap could be larger than the \$11 billion attributable to taxpayers understating their gains or overstating their losses because IRS did not estimate how much of the tax gap is attributable to individual taxpayers who did not file tax returns to report capital gains or did not pay the capital gains taxes they reported on filed returns.

⁶The securities transactions included in this estimate include sales of corporate stock, mutual funds, bonds, options, futures contracts, and capital gain distributions.

⁷26 U.S.C. § 6045(g); 26 C.F.R. §§ 1.6045-1, 1.6045A-1, 1.6044B-1.

begin collecting information on additional securities, beginning on January 1, 2012.⁸

Generally, a taxpayer's gain or loss from a securities sale is the difference between the gross proceeds from the sale and the original purchase price, or cost basis, net of any fees or commissions. However, to determine any gains or losses from securities sales, the taxpayer must determine if and how the original cost basis of the securities must be adjusted to reflect certain events, such as stock splits.⁹ For years, brokers have been required to report information on Form 1099-B such as descriptions of securities sold, sales date, and gross proceeds. However, the law changed what information is reported and who reports it. Prior to the law's effective date, the taxpayer was responsible for calculating cost basis and reporting it to IRS on their tax return. Now, brokers will be responsible for reporting cost basis information to taxpayers and IRS on the Form 1099-B. The Form 1099-B is due to taxpayers on February 15, and to IRS on February 28 for paper returns and March 31 for electronic returns, for the prior calendar year's security sales. Additional changes resulting from the law are described in table 4, appendix II.

Transaction Settlement Reporting

Transaction settlement reporting is expected to help IRS identify and prevent the underreporting of businesses income. Under the new requirements, all merchant transactions completed beginning on January 1, 2011, in which either a payment card or a third-party payment network is used as the form of payment, must be reported by payment settlement entities (PSE) on the new Form 1099-K, "Merchant Card and Third Party Network Payments."¹⁰ Information reporting on merchants—businesses that accept payment cards or payment from a third-party settlement

⁸Stocks other than those from a Regulated Investment Company (RIC) or a Dividend Reinvestment Plan (DRIP) require reporting starting January 1, 2011. Additional reporting requirements for RIC and DRIP stock, including mutual funds, begin with stocks acquired on or after January 1, 2012. Reporting requirements for additional applicable securities will begin on January 1, 2013. A broker could be a dealer, a barter exchange, or any other person who regularly acts as a middleman with respect to property or services. 26 U.S.C. § 6045(c)(1), (g).

⁹When a company declares a stock split, its share price will decrease, but a shareholder's total market value will remain the same. For example, if you own 100 shares of a company that trades at \$100 per share and the company declares a two for one stock split, you will own a total of 200 shares at \$50 per share immediately after the split.

¹⁰26 U.S.C. § 6050W; 26 C.F.R. §§ 1.6050W-1, 6050W-2.

organization for goods and services—is new for the transaction settlement industry.

A payment card is a card-based payment, such as a credit card, debit card, or prepaid telephone card, which is accepted by a group of unrelated merchants.¹¹ For example, a gift card for a shopping mall is a payment card because it is accepted as payment at a network of unrelated stores; however, a gift card for a specific store is not a payment card because it is only accepted by the store that issued it. A third-party payment network accepts various forms of payment from a customer to settle transactions with merchants who are unrelated to the network. Examples of third-party payment networks include PayPal, certain toll road automated payment systems, and certain shared service organizations (such as certain accounts payable services).¹²

A PSE—a bank or other organization that processes transactions and makes payments to the merchant accepting the payment card or the third-party settlement organization that makes payment to the merchant—is responsible for reporting payment card and third-party network transactions annually to IRS and to the merchant, on the Form 1099-K.¹³ The new requirements direct PSEs to report the gross amount of reportable payment transactions, which is the total dollar amount of aggregate transactions for each merchant, for each calendar year, without regard to adjustments for credits, cash equivalents, discounts, fees, refunds, or other deductions.¹⁴ In some cases, more than one PSE may be involved in a single transaction, in which case the PSE that actually makes payment to the merchant is responsible for filing the Form 1099-K.

¹¹Information returns are not required under the new law for instances where a person uses the payment card to withdraw cash, get cash advances, or when a convenience check linked to a payment card is accepted.

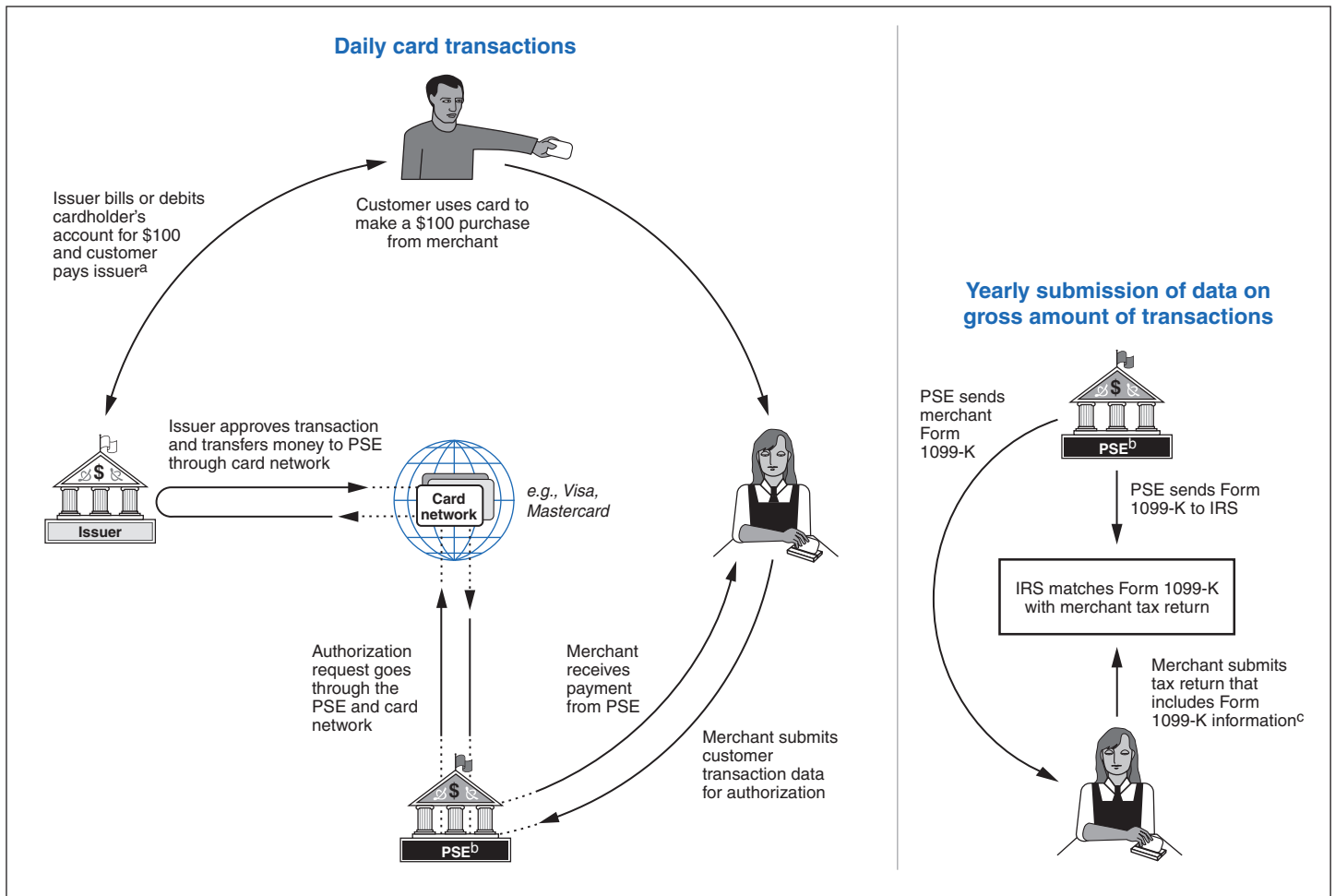
¹²Unlike payment card transactions, third-party network transactions are only reportable if a merchant's aggregate amount of such payments for the year exceeds \$20,000 and if the number of aggregate transactions exceeds 200. Payments to certain payees with a foreign address are not required to be reported as long as, prior to payment, the payer has documentation that the payee is a "foreign person."

¹³For a payment card, the PSE is an acquiring bank. For a third-party network, the PSE is a third-party settlement entity.

¹⁴Beginning in 2012, PSEs will be required to withhold 28 percent of the gross amount of transactions for merchants that do not have a valid taxpayer identification number (TIN), which could be a Social Security number. IRS uses TINs to match information returns to tax returns.

When a customer (cardholder) purchases goods or services from a merchant using a payment card, the merchant submits the transaction to the PSE for approval. The PSE submits a request through the card network, such as Visa or Mastercard, to the bank or other entity that issued the card (issuer). The issuer checks the customer's account to determine if the customer is able to cover the cost of the transaction. If so, the issuer bills or debits the customer's account for the amount of the transaction. Figure 1 shows this process for a typical credit or debit card transaction, two commonly used types of payment cards.

Figure 1: New Transaction Settlement Reporting Process for a Typical Credit or Debit Card Transaction



Source: GAO.

^aIn some cases, such as a credit card transaction, the issuer bills the customer and the customer may pay later. In other cases, such as a debit card transaction, funds are directly withdrawn from a customer's account.

^bThe PSE for credit card and debit card transactions is a merchant acquiring entity. An acquiring entity is a bank or other organization that makes payments to the merchant that accepts the credit card or debit card.

^cA merchant will receive one or more annual Forms 1099-K from each PSE that provides the merchant with payments. The merchant will file a tax return combining the total gross amount of transactions from all Forms 1099-K.

Third-party payment network transactions are similar to credit and debit card transactions in that the third-party network facilitates transactions between unrelated merchants and customers. Third-party payment

networks have widely varying business models, and can encompass many different types of payment situations that are not easily generalized, according to IRS officials and industry representatives. Typically, a customer pays the third-party settlement organization for a transaction with an agreed upon form of payment, which may include a payment card, and the third-party settlement organization settles the transaction with the merchant. One example of a third-party network is certain toll collection networks. Some states that operate toll roads contract with a third-party settlement organization to bill customers for road usage. The third-party settlement organization provides a system that allows the toll facility to record the passage of a vehicle with a transmitter inside. The third-party settlement organization periodically bills customers' accounts and makes payments to the state to settle the toll transactions.

IRS's New Compliance Program for Using Information Returns

IRS initiated the IRDM program in 2009 in part to implement the two new information reporting requirements, but more generally to increase voluntary compliance by expanding and maximizing its ability to use existing and future information returns and establishing a new business information matching program. Formerly, IRS had only matched information returns to individuals' and sole proprietors' tax returns.¹⁵ Under IRDM, IRS plans to build several new information technology (IT) systems and enhance some existing systems as well as implement numerous organizational and process changes. Specifically, IRS plans for IRDM to house a new process to use information returns to identify individual and business tax returns that are likely sources of revenue and that are overlooked by the current individual tax return matching system.

IRDM implementation involves many IRS groups and offices, and is led by the Small Business/Self Employed (SB/SE) division and Modernization and Information Technology Services (MITS). The Research Analysis and Statistics (RAS) division, the Office of Chief Counsel, and the Tax Forms and Publications group also have important roles in IRDM implementation. For example, RAS is working with IRDM on a research plan to assess the effectiveness of the program. IRDM capabilities will be implemented in stages, beginning in 2012.

¹⁵ A sole proprietor is an individual who owns an unincorporated business by himself or herself.

IRDM Implementation Plans Have Many Positive Aspects, but Could Better Demonstrate Coordination with Other IRS Projects, Adhere to Best Practices for Cost Estimation, and Use Reliable Data for Decision Making

IRDM Implementation Plans Address Several Key Areas for Effective Program Management

IRS developed a series of plans to implement the IRDM program, which will be used to implement the new cost basis and transaction settlement reporting requirements. IRDM plans cover program scope, management structures, information technology system development, communications with stakeholders, and other aspects of IRDM implementation.

We found that IRDM implementation plans generally are consistent with criteria for effective program planning and implementation listed in our prior reports and IRS guidance.¹⁶ For example, these criteria call for a leadership structure, an internal communication strategy, staffing and training provisions, a review process, risk management, and alignment with the agency strategic plan. IRDM has a leadership structure, headed by an executive steering committee at the highest level, with authority over the IRDM Governance Board whose functions include program management and coordination. It has a stakeholder management and

¹⁶To evaluate IRDM plans, we used criteria established by: IRS's *Internal Revenue Manual*; prior GAO work including GAO, *Internal Control Management and Evaluation Tool*, [GAO-01-1008G](#) (Washington, D.C.: August 2001); *Results-Oriented Cultures: Implementation Steps to Assist Mergers and Organizational Transformations*, [GAO-03-669](#) (Washington, D.C.: July 2, 2003); *Earned Income Tax Credit: Implementation of Three New Tests Proceeded Smoothly, but Tests and Evaluation Plans Were Not Fully Documented*, [GAO-05-92](#) (Washington, D.C.: Dec. 30, 2004); and other sources.

outreach plan that specifies communication strategies, as well as a detailed staffing and organizational development plan to implement document matching for business taxpayers. IRS's plans include provisions to review and assess the program for continuous improvement, such as a requirement to document lessons learned at the end of each significant project phase. Furthermore, IRDM has a plan that assesses and provides for the management of program risks and a plan that provides for analysis of related technology system interdependencies. IRS has begun implementing several of these plans, to various degrees. It is too early in the implementation process to comprehensively assess whether IRDM has followed all of its plans or achieved outcomes and whether these efforts will be effective.

Regarding the schedule of IRDM implementation, we found that IRS has met most time lines established in the program implementation plans, with two notable exceptions: the release of final regulations for cost basis and transaction settlement reporting, to be discussed later in this report, and certain software development milestones.¹⁷ Specifically, MITS did not meet milestone dates for the development and testing of the software expected to enhance IRS's ability to select potential individual taxpayer cases due to a procurement delay for the associated hardware, which delayed testing by 1 month. This software is also expected to aid in the development of a new IT system to select business taxpayer cases for review. In response to the delays, IRS officials said they have re-prioritized work and, as of May 2011, officials said they do not expect the delays to affect the program's progress.

IRDM Did Not Document Coordination with Related IRS Projects

The IRDM *Strategic Roadmap* is the foundational plan for IRDM that describes the program's scope, desired outcome, implementation phases, and time line. IRS guidance and our prior work state that comprehensive plans for implementing a new program should link with the agency's strategic plan and align with its core processes and agencywide

¹⁷The individual software development projects under MITS must pass through seven milestones before completion. A milestone is a point in time when management reviews updated cost, progress, and risk information. SB/SE activities and tasks other than IT development for IRDM are tracked separately. IRDM officials said they are working on developing a master schedule to integrate key dates of MITS projects and business activities.

objectives.¹⁸ The *Strategic Roadmap* is aligned with IRS's *Strategic Plan*, which guides and sets goals for IRS's work at a high level. For example, the *Strategic Plan* establishes a goal of enforcing the law to ensure that everyone meets their obligation to pay taxes which, according to the *Strategic Roadmap*, IRDM intends to support by using third-party information reporting to increase voluntary compliance and treat noncompliance.

However, the *Strategic Roadmap* and other IRDM plans do not document coordination with some significant recent and ongoing servicewide initiatives, such as *Workforce of Tomorrow* and the Nonfiler Strategy. IRS officials said they met with the initiatives' team members to coordinate, but did not document that coordination occurred and whether or how this coordination ensured that IRDM and other servicewide initiatives were consistent and would work well together.¹⁹ We did not find any aspects of IRDM plans that conflict with *Workforce of Tomorrow* or the Nonfiler Strategy, but documenting that IRDM plans are coordinated with servicewide initiatives would be consistent with internal control standards and could facilitate oversight, help prevent duplicative efforts, and foster a common understanding of program plans and activities.²⁰ For example, IRDM has a workforce plan for staffing a new organization to work business taxpayer cases identified by the new document matching process. The plan addresses hiring, training, and leadership, but does not show coordination with the servicewide Workforce of Tomorrow Task Force and its specific recommendations to improve IRS's overall recruiting methods, hiring strategies, and leadership development. The *Workforce of Tomorrow* report notes that better coordination of leadership development efforts across IRS could lead to more consistent

¹⁸GAO-01-1008G; GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996); and IRS, *Internal Revenue Manual: The IRS Balanced Performance Measurement System*, Section 1.5.1-5.

¹⁹The servicewide Workforce of Tomorrow Task Force engages a broad spectrum of IRS employees and critical stakeholders in identifying and understanding essential workforce issues and designing solutions. (IRS, *Workforce of Tomorrow Task Force Final Report*, Washington, D.C.: August 2009.) The servicewide Nonfiler Strategy aims to foster coordination among IRS programs to bring nonfilers into the tax system and ensure future compliance. Nonfilers are taxpayers who are required to file but do not file by the extended deadline.

²⁰GAO-01-1008G.

application of talent management tools and more effective use of processes and data for servicewide decision making.

IRDM is also planning new processes for identifying businesses that do not file tax returns, including an incipient business Automated Substitute for Return program.²¹ An IRDM plan recommends combining the planned business Automated Substitute for Return program with a related enforcement program for business nonfilers. This plan does not show coordination with IRS's servicewide Nonfiler Strategy or discuss the Nonfiler Strategy's potential effect on IRDM functions. IRS's Nonfiler Strategy noted that a lack of coordination in nonfiler work results in ineffective resource allocation. IRS provided us with a document that officials stated was used to inform the *Strategic Roadmap*; it cites how IRDM will make some accommodations for nonfiler programs, but it does not mention or discuss coordination with the Nonfiler Strategy.

IRDM plans could demonstrate coordination with *Workforce of Tomorrow* and the Nonfiler Strategy by describing IRDM's relationship with and its effect on these initiatives. After we discussed the issue with IRDM management in January 2011, officials said they are working to document this coordination in an updated version of the *Strategic Roadmap*, but they had not done so as of May 2011.

IRS Estimated SB/SE and MITS IRDM Costs, but MITS's Estimate Does Not Reflect Some Best Practices

SB/SE and MITS, the primary IRS divisions involved in IRDM implementation, each estimated their share of IRDM program costs for IRS's budget. SB/SE's first budget request for IRDM, about \$36 million, was made for fiscal year 2012.²² Officials expect that annual funding will increase as the program becomes fully operational and then remain steady for as long as IRDM continues to operate.

SB/SE worked with the IRS Chief Financial Officer's (CFO) office to develop its budget request. SB/SE calculated staffing needs based on the

²¹Automated Substitute for Return is a program to contact taxpayers who have not filed tax returns voluntarily and for whom income information is available to substantiate a significant potential income tax liability.

²²In previous years, MITS's funding included some SB/SE costs associated with IRDM, such as travel, while staffing for SB/SE's IRDM program management office was covered by SB/SE's general budget. Other IRS groups and offices that have staff working on IRDM tasks, such as RAS and the Office of Chief Counsel, also use their general budgets for IRDM work.

number and types of cases it anticipated, then used a calculator developed by the CFO's office to determine the cost of the staff, including salaries, benefits, training, facilities, and other direct and indirect costs.

MITS's work on IRDM was funded at \$23 million during fiscal year 2010, and IRS plans for funding to continue at this level through fiscal year 2016, yielding a total cost of about \$166 million for fiscal years 2009-2016.²³ MITS developed an initial cost estimate in 2008 to formulate its budget request. Total costs for IRDM since the program's inception are shown in table 1.

Table 1: IRDM Actual and Requested Funding Since Program Inception

Dollars in millions

Fiscal year	SB/SE IRDM costs			MITS IRDM costs	Total
	Cost basis reporting	Transaction settlement reporting	Other direct costs for both ^a		
2009 actual				\$5.1	\$5.1
2010 actual				\$23.0	\$23.0
2011 actual				\$22.9	\$22.9
2012 requested	\$1.3	\$27.5	\$6.9	\$23.2	\$58.9
Total, 2009 through 2012					\$109.9

Source: Fiscal year 2012 budget request for IRS and IRDM budget documents.

^aOther direct costs for both cost basis and transaction settlement reporting include handling appeals, litigating cases not resolved by audit or appeal, and ensuring that staff are available for related operations such as accounts management and submission processing.

According to best practices established by the *GAO Cost Estimating and Assessment Guide*, a cost estimate should be comprehensive, well documented, accurate, and credible.²⁴ However, MITS's IRDM cost estimate does not fully meet these four best practices (for a description of the best practices and the extent to which MITS met each characteristic, see app. III). For example,

²³MITS received about \$5 million in IRDM funding in fiscal year 2009.

²⁴GAO, *GAO Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, [GAO-09-3SP](#) (Washington, D.C.: Mar. 9, 2009).

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- The estimate substantially meets the best practices for a comprehensive cost estimate.²⁵ The estimate covers most life-cycle costs, is supported by a document that defines the work needed to accomplish the program’s objectives and relates cost and schedule to deliverables, and provides technical descriptions for each project phase.²⁶ However, although it defines assumptions and estimating standards, also referred to as ground rules, the cost estimate does not cite a rationale for the assumptions and only considers the impact of risks on a portion of the estimate.²⁷
 - The estimate partially meets best practices for a well documented cost estimate. It provides technical descriptions for each project phase and documents a management briefing, but it does not contain many details about the underlying data used to develop the estimate. MITS used a computer model to calculate the cost estimate, but the formulas built into this model and the resulting calculations are not shown. Thus, it would not be possible for another cost analyst outside IRS to use available documentation to recreate the estimate without access to this computer model. Moreover, although IRS provided documentation of its general cost estimation methodology, the methodology used to develop this cost estimate was not provided at a meaningful level of detail.²⁸
 - The estimate partially meets best practices for an accurate cost estimate. The model used to calculate the estimate was developed using data from other comparable projects, which provides insight into

²⁵We rated the extent to which IRS met each best practice on the following scale: “Meets,” IRS provided complete evidence that satisfies the entire criterion; “Substantially meets,” IRS provided evidence that satisfies a large portion of the criterion; “Partially meets,” IRS provided evidence that satisfies about half of the criterion; “Minimally meets,” IRS provided evidence that satisfies a small portion of the criterion; and “Does not meet,” IRS provided no evidence that satisfies any of the criterion. See app. I for further description of our scope and methodology.

²⁶The full life cycle of a program includes inception, design, development, deployment, operation, and maintenance, until the program is retired.

²⁷Ground rules are a set of estimating standards that provide guidance and minimize conflicts in definitions, while assumptions are judgments about past, present, or future conditions that may affect the estimate.

²⁸MITS’s general cost estimation methodology is documented in its *Estimator’s Reference Guide*.

actual costs on similar programs.²⁹ However, inflation was not included. According to IRS officials, inflation is not applied to cost estimates because it is factored in automatically during the budget process. If inflation were included in the cost estimate, it would be double-counted in the budget. Applying inflation is an important step in creating a cost estimate and it is a best practice for inflation to be included and documented when creating cost estimates. Cost data must be expressed in like terms, which requires the transformation of historical or actual cost data into constant dollars. Additionally, the cost estimate does not explain variances between planned and actual costs because the estimate was developed before the program started; there were no actual IRDM cost data available. A comparison between the original estimate and actual costs would allow estimators to see how well they are estimating and how the program is changing over time. In 2008, the Treasury Inspector General for Tax Administration (TIGTA) recommended that IRS provide similar information.³⁰

- The estimate minimally meets best practices for a credible cost estimate. It contains a risk analysis, but it only addresses risks on a small portion of the overall costs and how the risk analysis was done is not clearly documented. IRS performed a cross-check on the estimate by using an alternative estimation method to see if it produced similar results. Specifically, IRS did one cross-check by comparing the estimate to an expected ratio of operations costs and nonrecurring costs. However, there was no evidence that other cross-checks were performed. Further cross-checks using different calculation methods could enhance the estimate's reliability if they showed that different methods produce similar results. In addition, the cost estimate does not contain a sensitivity analysis, which would examine the effects of changing assumptions and estimating procedures and therefore highlight elements that are cost sensitive.³¹ IRS officials said they

²⁹IRS used a commercially available information technology cost model to calculate MIT's IRDM costs. Though the model is based on historical costs from comparable projects, assumptions that IRS applies to the model, such as that no additional functionality would be required to validate taxpayer identification numbers, are not supported by historical information.

³⁰TIGTA recommended that the IRS Chief Information Officer ensure the reliability of the cost estimation process by implementing procedures to compare actual project operations and maintenance costs to initial estimates and revise the estimation process, if necessary. (Treasury Inspector General for Tax Administration, *The Modernization Vision and Strategy Program Is Achieving Desired Results, but Risks Remain*, Reference No. 2009-20-008 (Oct. 31, 2008).)

³¹A sensitivity analysis examines how changes to key assumptions and inputs, such as the proportion of forms that will be filed electronically, affect the estimate.

typically do not perform a sensitivity analysis unless the program has reached its preliminary design phase, which was not the case when they estimated IRDM costs. Furthermore, although the IRS group that did the cost estimate was independent from the IRDM program office, IRS did not obtain an independent cost estimate conducted by an outside group to validate it. According to officials, due to limited resources, IRS generally only does an additional independent cost estimate for its largest programs and does not do an additional estimate for a cost estimate done at the start of a program. Therefore, because IRDM is not a large program, according to officials, and because its cost estimate was done before the program started, an additional independent cost estimate was not done. Although we recognize that it would be challenging for IRS to do an independent cost estimate for each project because IRS lacks the resource to do so, it is a best practice to do an independent cost estimate because it would provide an unbiased test of whether the original cost estimate is reasonable.

IRS officials said that, because their cost estimation procedures became more robust after this cost estimate was prepared in 2008, a revised cost estimate would follow best practices to a greater extent. Officials also said that they could more accurately estimate costs now that they know more about the IRDM program, and that they are considering revising the estimate but may not do so due to limited resources. If IRS revises the IRDM cost estimate, following best practices from our cost estimating guide could enhance its reliability.³²

IRS Did Not Use Substantiated Projections of Form 1099-K Volume for IRDM Resource Planning Decisions

IRDM did not use substantiated volume projections for the new Form 1099-K in some of its budget and risk management decisions because official projections were not available when those decisions were made. Making decisions without substantiated projections puts IRS at risk for misallocating resources. To support sound decisions, the source or method for obtaining data supporting decisions should be documented. IRS research standards say that data must be validated, any limitations must be disclosed, and documentation must be made available.³³ More specifically, IRS and industry guidance establish that estimates used in project planning should have a sound basis and documentation to instill

³² [GAO-09-3SP](#).

³³ IRS, *Internal Revenue Manual: Servicewide Research Data Standards*, [Section 1.7.2](#).

confidence that any plans based on estimates are capable of supporting project objectives.³⁴

IRS produced three different projections of the number of Forms 1099-K, expected to be filed annually. One of these—the projection a contractor developed in 2010 to assess the capacity of MITS’s Filing Information Returns Electronically (FIRE) system³⁵—was developed without consulting RAS, which produces form volume projections that IRS considers reliable. This projection, and the 125 million projection SB/SE developed in 2006, also lack documentation of the assumptions and methods used to develop them. Table 2 describes the three Form 1099-K volume projections and the decisions that were based on them.

Table 2: IRS Projections of Annual Form 1099-K Volume

Projection	Description	Resource planning implication	Includes detailed supporting documentation
125 million	SB/SE produced this projection in 2006, in anticipation of possible payment card reporting legislation.	SB/SE used this projection, in part, to develop original budget and staffing estimates for SB/SE’s fiscal year 2012 IRDM budget request.	No
60 million	A contractor developed this projection to use in its study assessing the capacity of IRS’s FIRE system. This FIRE Capacity Study was released in August 2010.	The FIRE Capacity Study explored several scenarios that rely on Form 1099-K and Form 1099-B volume projections. It concluded that FIRE is adequately sized to handle the worst case volume scenarios.	No
54 million	RAS produced this preliminary projection in December 2010. ^a	This projection has supporting documentation that explains its methodology and assumptions, but it was not done in time to be used in IRDM resource planning decisions, such as SB/SE’s fiscal year 2012 IRDM budget request.	Yes

Source: GAO analysis of IRS data.

^aRAS publishes yearly projections of information returns to assist IRS staff with their budget submissions and staffing estimates. The 54 million projection is a preliminary estimate. To finalize this estimate, RAS is refining its approximation of the number of Forms 1099-K that will be filed for each business. RAS plans to release the official projection in summer 2011.

The 125 million projection was used in part to calculate SB/SE’s fiscal year 2012 request for about \$36 million and 415 full-time equivalent staff: it

³⁴Carnegie Mellon University Software Engineering Institute, *Capability Maturity Model Integration for Development* (Pittsburgh, Pa.: August 2006); IRS, *Enterprise Lifecycle Guidance*.

³⁵The FIRE system is the IRS portal that receives incoming information returns filed electronically.

factored into staffing calculations such as the number of employees needed to screen potential cases and respond to discrepancies between Forms 1099-K and related business tax returns. Other data also factored into these budget and staffing calculations.³⁶ In addition, the 60 million projection was used to make decisions about MITS information technology needs. The supported preliminary Form 1099-K projection produced by RAS is less than half of the projection used to inform SB/SE's staffing calculations. IRDM officials were unable to provide documentation of the methodology used to develop SB/SE's 125 million projection, but did provide us some of the assumptions. The FIRE Capacity Study does not provide sufficient methodology or documentation to support its findings, including its Form 1099-K projection. For example, the study says that the assessment team obtained future volume projections by holding meetings and exchanging e-mails, but does not explain how those projections were calculated or the basis of the information. IRDM identified the potential for new information returns to strain FIRE's capacity as a program risk. The contractor's capacity study, which IRS intended to address this risk, cannot reliably do so without substantiated data inputs.

RAS is responsible for producing reliable form volume projections for IRS decision making, but RAS had not yet produced an official Form 1099-K projection at the time of the formation of the fiscal year 2012 IRDM budget request and the FIRE study's release.³⁷ RAS officials were not involved in developing the projection used in the FIRE Capacity Study. Consulting RAS when using Form 1099-K projections in decision making could enhance the reliability of those projections. Since we identified the issue, officials said they plan to reassess whether the FIRE system can handle incoming information returns using RAS's preliminary projection, but they had not done so as of May 2011.

³⁶Other data that IRS used in its budget and staffing calculations included the projected number of related tax returns and anticipated mismatches between tax returns and information returns. SB/SE's fiscal year 2012 budget and staffing request also includes resources to work cases on individual taxpayers.

³⁷RAS projections are released annually in IRS *Publication 6961, Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses*.

Additional IRS Communication and Guidance, and Release of Future Draft Form Instructions, Could Benefit Industry Implementation

IRS Communication with Industry Stakeholders Early in the Rulemaking Process Was Thorough

Prior to preparing the proposed regulations for cost basis and transaction settlement reporting, IRS counsel met in person and via phone with industry stakeholders to gain an understanding of issues facing the industries.³⁸ Treasury officials, who worked with IRS and ultimately approve the regulations, also met with industry stakeholders. Additionally, prior to publishing proposed regulations, IRS posted notices in the Internal Revenue Bulletin to solicit responses to questions and comments on, among other things, the definitions of key terms.³⁹ Representatives from the four cost basis and transaction settlement industry groups we interviewed said IRS was responsive to their concerns and that its initial outreach and information gathering efforts were good. In addition to direct communication with industry groups, IRS also relied on the Information Reporting Program Advisory Committee (IRPAC), whose members include tax professionals and industry representatives, for input.⁴⁰ Once each of the two proposed regulations were published, IRS conducted a public hearing and officials communicated with industry through the public comment letter process. As evidenced in lessons learned from a prior IRS

³⁸For the purposes of this report, the cost basis industry includes brokers and entities that support brokers by providing goods or services, such as technology systems. The transaction settlement industry includes payment settlement entities and entities that support them.

³⁹Notice and comment procedures are defined in the Administrative Procedure Act. This typically means that an agency will (1) publish a notice of proposed rulemaking; (2) provide an opportunity for public comment, usually through letters, on the proposed rule; and (3) after the comment period, publish a final rule. 5 U.S.C. § 553.

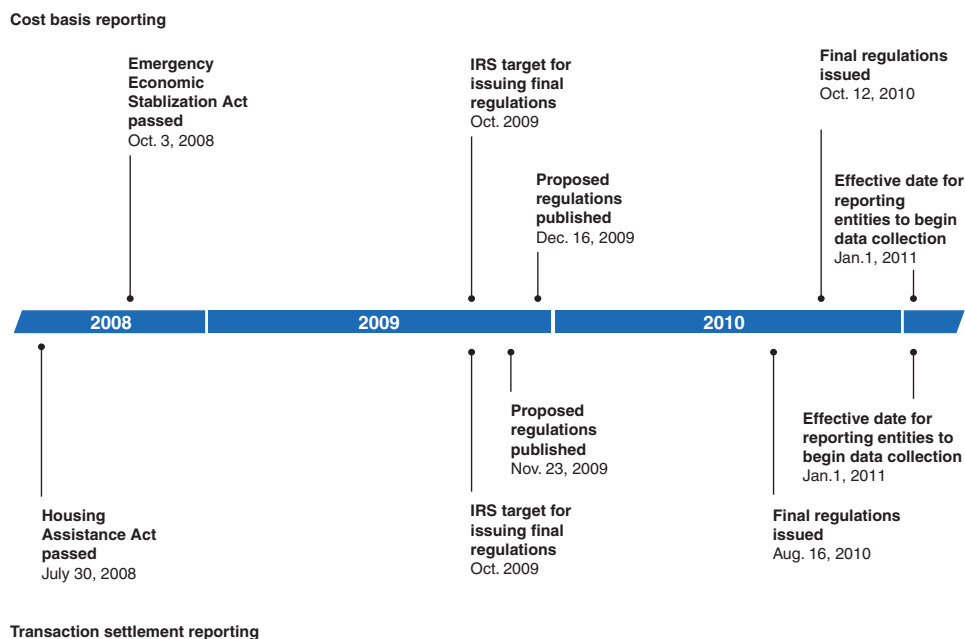
⁴⁰IRPAC is an advisory body to the Commissioner of Internal Revenue on information reporting issues. IRPAC is not permitted to engage in lobbying activities, but may comment on the benefits and burdens of legislation that includes tax information reporting provisions.

implementation effort, this early engagement of external stakeholders is important in the development of the compliance and operational functions for new tax legislation.⁴¹

Despite Noteworthy Efforts, IRS Did Not Meet Its Target Dates for Issuing Regulations

Due, according to IRS officials, to unanticipated complexities of the cost basis and transaction settlement industries, IRS counsel did not meet its target dates for issuing final regulations for either reporting requirement, as shown in figure 2.

Figure 2: Key Dates for Cost Basis and Transaction Settlement Reporting Rulemakings



Source: GAO analysis.

Final regulations on cost basis reporting were issued in October 2010, and for transaction settlement reporting in August 2010. Both laws establish January 1, 2011, as the effective date for data collection to begin—over 2 years after the laws' enactment in 2008. Reporting data are due to IRS in 2012 for both laws.

⁴¹IRS, *Recovery Act Lessons Learned* (November 2010).

Although IRS missed its target dates by about a year, the turnaround for finalizing regulations was relatively fast, according to IRS counsel, especially when compared with other information reporting rulemaking.⁴² One cost basis group acknowledged the short time between the enactment and the effective date of the laws. IRS officials said that the rulemakings did not meet deadlines because the cost basis and transaction settlement industries were more complex than they anticipated and learning them required more time than expected. Furthermore, according to IRS counsel, IRS does not have complete control over the timing of the issuance of regulations because they must be approved by the Department of the Treasury, which sets priorities for when regulations are issued.⁴³ The cost basis and transaction settlement reporting regulations were given priority, having been listed in Treasury's *2009-2010 Priority Guidance Plan*.⁴⁴ However, Treasury counsel said the rulemakings posed unique challenges, such as learning new systems and becoming familiar with the industries affected by the regulations. Another Treasury official said that their review process for these regulations was relatively fast given the complexities. After the final regulations were issued, the cost basis and transaction settlement industries had, respectively, 2 ½ months and 4 ½ months before data collection was to begin.

According to IRPAC and representatives from both industries, the timing of final regulations left the industries with a short implementation time. Three cost basis groups said that while the legislation was under development, they requested from congressional staff 18 months to implement any information systems or other changes needed to comply with final regulations; third-party payment networks said they requested a year. A senior IRDM official said companies could have started systems

⁴²For example, legislation requiring withholding on all payments made by federal, state, or local government entities to persons providing property or services was enacted in 2006, and is not effective until 2012. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 511, 120 Stat. 343, 364–365 (2006) as amended by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, div. B, § 1511, 123 Stat. 115, 355 (2009). IRS issued these proposed regulations on December 5, 2008 and final regulations were published on May 9, 2011. 73 Fed. Reg. 74,082; 76 Fed. Reg. 26,583.

⁴³According to counsel at Treasury, in addition to regulations, they must approve material posed in the Internal Revenue Bulletin, with a few exceptions. Informal guidance that does not include substantive policy decisions, as is typically the case for Frequently Asked Questions (FAQ), does not need to go through a review process with Treasury.

⁴⁴The Priority Guidance Plan is an annual publication by Treasury and IRS that lists projects that are priorities for allocation of the resources of both offices, and it is used to identify and prioritize tax issues that require regulations or other actions.

development before regulations were final. Although some cost basis and transaction settlement industry members used proposed regulations to guide their initial implementation, IRPAC representatives said companies had to make some assumptions about what would be in the final regulations, which increases costs.

The short implementation time may affect the quality of data sent to IRS. One cost basis industry group told us that small firms may not be ready to comply with the regulations and, as a result, taxpayers and IRS may receive inaccurate data on the Form 1099-B from those firms. Although cost basis industry representatives believe it is too soon to tell which data quality issues will be most pressing, they pointed out that there may be significant inconsistencies in gifted and inherited securities because calculation methods are unclear and systems were not fully prepared for implementation. If these securities are transferred to other brokers, data quality issues may follow, resulting in long-term consequences for securities gifted or inherited in 2011, but sold in later years. A transaction settlement industry group identified several issues as potential data quality challenges, including that the industry does not identify merchants based on Taxpayer Identification Numbers (TIN). According to third-party payment network representatives, it is too soon to tell how data may be affected by the short implementation time.

Additional IRS Communication on Rulemaking, Guidance, and Outreach May Improve Industry Implementation

After IRS's issuance of final regulations, industry stakeholders sought clarification of certain issues. IRS did not provide additional written guidance or participate in outreach events until after the effective dates of the regulations. IRS officials told us that timing of the additional guidance resulted from a lengthy review process, which included IRPAC's review of FAQs for transaction settlement regulations. Regarding outreach, IRDM officials told us that IRDM planned to begin outreach once final regulations were issued so that messages would be based on stable information. Continuous engagement of external stakeholders is important to ensure compliance with new tax legislation.⁴⁵

Because IRS did not release clarifying guidance or continue outreach until after the effective dates of the laws, industry groups experienced a gap in communication from IRS which, according to industry representatives, could affect implementation. Four industry groups told us after the final

⁴⁵IRS, *Recovery Act Lessons Learned* (November 2010).

regulations were issued that they were awaiting additional information, including clarification on certain reporting responsibilities, which could affect their implementation of the laws. For example, one cost basis group pointed out that taxpayer confusion associated with reporting wash sales may cause a large volume of corrected Forms 1099-B during the year following implementation.⁴⁶

IRS released a Frequently Asked Questions (FAQ) document for cost basis reporting on its [Web site](#) in March 2011. For transaction settlement reporting, as of May 4, 2011, IRS had not released additional written guidance since issuing the final regulations. IRS counsel said some transaction settlement companies and cost basis entities have contacted them about technical details of implementation, such as filling out forms, and that IRS has spoken with them. Additionally, outreach events that will cover both laws, such as speaking at events for tax professionals, began in February 2011 and, as of April 2011, are scheduled through November 2011. IRPAC and two industry groups we spoke with said they are not always aware of IRS's plans for issuing guidance or beginning additional outreach.

The transaction settlement industry's implementation also could be affected by the gap in guidance and outreach after the regulations were issued. For example, the definition in the regulations for "third-party payment network" is broad, according to representatives of several third-party payment network companies. The definition could lead some companies to question whether they will need to file a Form 1099-K, according to the companies. IRS counsel acknowledged that the applicability of the definition depends on a company's specific business model and said the regulations could not address all possible examples of third-party payment networks. IRS counsel said they plan to post FAQs on their Web page and to do letter rulings on request.⁴⁷ Third-party payment network representatives we contacted told us they were unaware of IRS's plans.

⁴⁶If a taxpayer acquires a stock or security within 30 days of selling a substantially similar stock or security, the taxpayer is not generally permitted to claim a loss on the sale (commonly referred to as a wash sale). 26 U.S.C. § 1091; 26 C.F.R. § 1.1091-1.

⁴⁷A letter ruling is a written determination issued to a taxpayer in response to the taxpayer's written inquiry, filed prior to the filing of returns or reports that are required by the tax laws, about its status for tax purposes or the tax effects of its acts or transactions. Taxpayers are charged a fee for this assistance.

In addition to IRS counsel's communication with reporting entities, IRDM established a team and a plan for stakeholder outreach. IRDM hired an employee shortly after the laws' effective dates to lead the communication team, and IRDM participated in its first external outreach event at the end of February 2011. Earlier action by the IRDM outreach team might have helped to bridge the communication gaps between IRS and the cost basis and transaction settlement industries. Earlier outreach might have also helped IRS raise awareness among companies, such as certain third-party payment networks, who may not be aware that they will be required to report. The *IRDM Stakeholder Management and Communication Plan* provides a potentially useful framework to analyze stakeholders' concerns and to prescribe appropriate IRDM responses. For example, the plan describes a methodology for analyzing the potential effect of IRDM regulations on stakeholder groups, and the degree of influence of each stakeholder. The IRDM team is to analyze stakeholder concerns and ideas, summarize trends, and develop strategies for specific groups. The plans also emphasize the need to gauge the effectiveness of IRDM communications. This framework, if followed, could be a useful tool to help identify and assess stakeholder needs.

IRS already has a [Web page](#) on cost basis, transaction settlement, and other new information reporting requirements. The page contains copies of the information returns and regulations for both laws, cost basis FAQs, and, for transaction settlement stakeholders, instructions for using IRS's TIN Matching Program.⁴⁸ The page does not contain prospective information about upcoming guidance or outreach or, for other information reporting laws, upcoming rulemaking actions. The Department of Transportation has a [Web page](#) that contains information about the status of significant rulemakings, including scheduled milestones, actual dates that milestones were met, and explanations for any delays. The page is a public version of more detailed internal tracking of rulemaking milestones and assessing schedules, which helps department officials determine if a rule is on or behind schedule, based on target dates.⁴⁹ A representative from a cost basis industry group referred

⁴⁸The TIN Matching Program is a computer system that permits payers to check the TIN furnished by the payee against the name/TIN combination contained in the IRS's database maintained for the program. IRS will then inform the payer whether or not the name/TIN combination matches a name/TIN combination in the database.

⁴⁹See GAO, *Federal Rulemaking: Improvements Needed to Monitoring and Evaluation of Rules Development as Well as to the Transparency of OMB Regulatory Reviews*, [GAO-09-205](#) (Washington D.C., Apr. 20, 2009).

us to a similar [Web page](#) run by the Financial Industry Regulatory Authority, which also contains outreach information on securities regulations.⁵⁰

Additional Web-based information from IRS, such as information about upcoming events or IRS's approach to letter rulings, could benefit industry stakeholders. IRS could use the Transportation or Financial Industry Regulatory Authority pages as a guide for enhancing its Web-based information on regulations and guidance, and could also include outreach information. Such information could be especially helpful for the cost basis industry as IRS begins a new rulemaking for additional securities that will be required to collect cost basis information beginning in 2013. Representatives from the cost basis and transaction settlement industries said such a Web page, if kept up to date, would aid in their implementation of the laws.

Officials at IRS told us their ability to provide projected issuance dates for regulations is limited by the uncertainties in Treasury's review process. An official in Treasury's Office of Tax Policy agreed that their review process, which could result in significant revisions, makes it challenging to post projected release dates that are useful and accurate. According to the official Treasury does not have an internal system for tracking rulemaking. However, Treasury and IRS officials could work together to provide projected release dates to the public. Posting other information, such as upcoming outreach events and the release of informal guidance, such as FAQs, would also be beneficial.

IRS Did Not Release Draft Instructions for the Forms 1099-K and 1099-B for Public Comment

IRS released draft versions of the new Form 1099-K and the revised Form 1099-B for tax year 2011 when it released the proposed regulations in late 2009 for each law; however, IRS did not release draft instructions for either form because, according to officials, they were not complete at that time. IRS solicited comments on the forms during the rulemakings process and continued communication afterwards with industry groups as new drafts were created.⁵¹ IRS has since posted final instructions for both

⁵⁰The Financial Industry Regulatory Authority, Inc. is the largest independent regulator of securities firms that do business in the United States; it is a nongovernmental entity.

⁵¹An IRS official told us that IRS did share the draft instructions for the Form 1099-B with IRPAC, but not with any other external industry stakeholders. IRPAC received a copy of draft Form 1099-K instructions one business day prior to their public release.

forms, and officials told us they are taking comments on the instructions through August 2011.⁵²

IRPAC representatives said they were unable to adequately comment on the draft forms without seeing definitions and other explanations typically included in instructions, and cost basis and transaction settlement industry stakeholders also emphasized the need for instructions to help in their implementation of the laws. Not having instructions available when draft forms were issued left industry stakeholders with some key unanswered questions, whose outcomes may affect their system development efforts and ultimately data reported to taxpayers and IRS. For example, some transaction settlement representatives asked IRS why the Form 1099-K requests the gross amount of “payments” rather than the gross amount of “reportable payment transactions” as required in the regulations. For the transaction settlement industry, there is a difference between a payment and a transaction that could affect the dollar amount reported. Specifically, the transaction amount of a purchase will almost always be greater than the payment actually received by a merchant, due to fees charged by the PSE, card issuers, or other entities facilitating the transaction. The draft instructions explained what was meant by the term “payments.” If transaction settlement groups had viewed the draft instructions with the draft forms, their concerns may have been addressed earlier and they could have proceeded with greater confidence in designing their data collection processes.

IRS officials acknowledged that some comments made on the forms could have been avoided if the instructions were available. According to IRS officials, releasing draft instructions with draft forms is usually not done because instructions are typically not complete by the time forms go out for comment. However, IRS officials said they have released draft instructions with forms on occasion and recognize the value in doing so.

⁵² A final version of Form 1099-K and instructions was released in February 2011. IRS also released a final Form 1099-B at that time, but then removed a box and reissued a draft Form 1099-B in March 2011. The final Form 1099-B and instructions were released in March 2011.

IRDM Plans for IT Systems, New Workflows and Organization, and Research Are Expected to Improve the Compliance Programs for Individual and Business Taxpayers

Planned Enhancements Should Allow for New Information Return Data to be Used in New and Existing Compliance Efforts

IRDM's plans to use the new cost basis and transaction settlement reporting data rely upon new IT systems that are expected to automatically match information returns to tax returns. The plans also provide for a new organization and new workflows for business taxpayer compliance staff. The specific plans for electronically processing the new information return data were nearly complete, as of May 2011, according to a senior IRDM official. The initial round of IT enhancements is to be operational in 2012, utilizing tax year 2011 data, and over 400 full-time equivalent staff have been requested in IRS's fiscal year 2012 budget to, among other things, transcribe new business tax return information and reconcile returns. Additional IT enhancements are planned for subsequent years. Eventually, all current and future information return data will go through the IT systems created for IRDM. (For additional details on planned implementation time frames, see app. IV, table 6.)

The two existing programs that will be affected by IRDM are IRS's Automated Underreporter program (AUR) and nonfiler programs. The existing AUR matches data on information returns and income reported by individual taxpayers only.⁵³ A notable planned AUR improvement is the

⁵³AUR handles cases where a taxpayer underreported payments on his or her tax return or overclaimed certain deductions (i.e., mortgage interest, real estate taxes). After mismatches are identified by IRS's computer systems, AUR reviewers manually screen cases to determine whether the discrepancy can be resolved without taxpayer contact. For the remaining cases, IRS may send a notice to the taxpayer.

development of technology to match data from the Form 1099-K to business tax returns.⁵⁴ The existing IRS nonfiler programs work individual taxpayer and business nonfiler cases. IRS recently implemented a project to modernize its business nonfiler compliance program and IRDM is developing plans to use and work with that project, according to a senior IRDM official.⁵⁵ In particular, IRDM is assessing the feasibility of establishing a business version of the program IRS uses to estimate taxes owed, known as the Automated Substitute for Return program, and submit a return on behalf of individual nonfilers. A summary of the planned IRDM improvements is shown in table 3.

Table 3: IRS's Existing Process Characteristics Compared with Plans for the IRDM Program

Existing process characteristics	IRDM planned improvements
Only individual taxpayer data are used in matching and AUR.	Include business taxpayer data in matching and AUR.
IRS receives more third-party data for business taxpayers than are used in matching.	Utilize data that IRS receives for compliance.
Paper-based case files that are referred between IRS functions, lead to delays.	Scan documents to enable electronic case management and notice generation.
IRS employees working cases do not have data from AUR, nonfiler, and other programs.	Combine data from the AUR, nonfiler, examination, and other areas for employees to use when working cases.

Source: GAO analysis of IRDM plans and existing IRS compliance programs.

The IRDM IT systems are also intended to overcome several limitations in IRS's existing matching program, which will allow for better use of data, including Form 1099-B data.⁵⁶ For example, IRDM is planning to update rules—criteria for selecting cases—based on prior case results and other data.⁵⁷ These rules are important for IRS to target the cases with potential

⁵⁴Form 1099-K data on merchants' gross income will be matched to the following tax returns: Form 1120, Form 1120-S, Form 1065, and Form 1040 Schedules C, E, and F, according to IRS officials.

⁵⁵For more information on the business nonfiler program, see GAO, *Tax Gap: IRS Has Modernized Its Business Nonfiler Program but Could Benefit from More Evaluation and Use of Third-Party Data*, [GAO-10-950](#) (Washington D.C.: Aug. 31, 2011).

⁵⁶Form 1099-B data on securities sales will be matched to the following tax returns: Form 1040 Schedule D and Form 8949, according to IRS officials.

⁵⁷Other potential criteria include, whether a taxpayer uses a tax preparer, receives other Forms 1099, or lives in a particular region, according to a senior IRDM official.

tax assessments. With the existing system, rules are difficult to update.⁵⁸ Because this will be the first time IRS includes businesses in the document matching program, IRS must establish rules for businesses. IRDM is conducting research to establish an initial rule set for tax year 2011, according to a senior IRDM official. As IRS gains information on business cases, the rules are to be refined. Eventually, according to the senior official, they would like to use industry data on the usage of payment cards to profile and segment business tax returns for appropriate treatment.

IRS also plans to develop new technology to help manage individual and business cases and, eventually, to contact business taxpayers automatically through notices. Additionally, IRDM is intended to enable monthly updates and storage of 10 years worth of information return data, thereby modernizing the existing reliance on files that cannot be updated frequently. IRS expects to accomplish this by using the Integrated Production Model (IPM) database to house the data that feed the matching processes.⁵⁹ IPM is designed to serve as a central repository for compliance data. It includes taxpayer data from databases known as Master Files, which contain taxpayer and business account information. In addition to the new matching technology, IRDM's planned changes will facilitate the use of data among compliance staff. Appendix IV, figure 3 shows an overview of the planned state for information return processing once IRDM is fully implemented.

As of May 2011, IRS was developing some details of the plans to use the new data. For example, IRDM officials were determining how certain

⁵⁸We previously recommended that IRS periodically and regularly evaluate the business rules used to generate notices, and that IRS collection managers and executives have access to collection information for taxpayers delinquent in paying their taxes. As of November 2010, IRS has not implemented the recommendations. See GAO, *Tax Debt Collection: IRS Needs to Better Manage the Collection Notices Sent to Individuals*, [GAO-09-976](#) (Washington, D.C.: Sept. 30, 2009).

⁵⁹IPM is expected to include individual taxpayer data from the Customer Account Data Engine (CADE) 2 database, which is under development. See GAO, *Taxpayer Account Strategy: IRS Should Finish Defining Benefits and Improve Cost Estimates*, [GAO-11-168](#) (Washington D.C., Mar. 24, 2011).

business taxpayer cases will be sent to, and worked, in IRS's Large Business and International division.⁶⁰

IRS intends for the individual AUR program to benefit from IRDM, but potential resource limitations could affect the individual AUR program. IRDM was developed under the assumption that the program cannot harm the operations and production of the current individual AUR program, but officials acknowledge some risks exist. For example, IRDM plans acknowledge a risk of personnel gaps in the individual AUR program if a large number of those staff are hired into the business matching program. IRDM plans also suggest that if funding is not received for fiscal year 2011, staff from the individual program may be diverted from their current work to help work in the business matching organization. IRDM considers the risk of not receiving 2011 funding to have a low probability of occurring and, if it does occur, IRDM predicts a moderate impact on schedule. As of May 2011, according to a senior IRDM official, IRS does not plan to realign individual AUR staff during fiscal year 2011, but a lack of funding will impact the number of test cases IRS can complete.

Research and Testing Are Key Determinants of How Effectively IRS Will Use the New Information Return Data

IRS's effective use of the new information return data to promote compliance, particularly in initial years and for business filers, will rely heavily on research to design the matching program, set initial case selection criteria, and to ensure that data feeding the IT systems are accurate. To design the data matching program, IRS is evaluating filing patterns of taxpayers and information return filers to determine when, and how often, matching can be performed, according to a senior IRDM official.

To develop initial rules for selecting businesses to contact when the document matching program identifies discrepancies between Forms 1099-K and business tax returns, IRDM has conducted, and continues to conduct, research on how to best identify revenue-producing business taxpayer cases. Specifically, IRS completed a manual review of documents already filed by small corporations to estimate the volume, amount, and potential tax revenue that may be collected by contacting taxpayers about unreported income. After contacting taxpayers about

⁶⁰Small business underreporter cases identified through IRDM will be worked in a new organization within SB/SE. Cases involving large businesses or international entities will be sent to the Large Business and International division.

income discrepancies, 21 percent of the cases resulted in a tax assessment. IRS is doing a follow-up study that will provide, among other things, additional information on business case tax revenue, taxpayer response rates to notices, and hours spent per case. This research will help establish a skeletal set of case selection criteria for 2011 data, according to a senior IRDM official. The results of this, and other research, will support additional details in IRDM's planned use of the new data.

When the new data arrive in 2012, IRDM plans call for data quality testing, prior to matching, on 2011 Form 1099-K data. Data quality testing could identify potential reporting errors which industry groups are concerned about. The testing, and mitigating adjustments based on any errors found, will be key to ensuring the long-term ability of IRDM's IT systems to identify productive cases.

IRS Has Plans to
Assess
Implementation and
Outcomes, but Needs
to Identify and
Document IRDM
Performance
Measures Early on to
Ensure Necessary
Data Collection

IRDM Is Documenting Lessons Learned, but Lacks Accountability for Implementing Improvements

At the end of each IRDM IT project milestone IRDM produces a lessons learned document, in accordance with IRS's Enterprise Lifecycle Guidance, which requires a lessons learned report at the end of each life-cycle phase.⁶¹ Lessons learned can be useful tools for an organization to identify areas of improvement as well as ways to make those improvements. The IRDM lessons identified at the end of Milestone 2 detail eight problem areas and ways to prevent them in the future.

IRDM does not include a plan for accountability, such as assignment of implementation responsibility and a periodic review of the lessons learned to ensure the improvements are implemented. For four of the Milestone 2 lessons, IRDM documented some actions to take to address each issue. IRDM did not document those individuals or offices responsible for implementing corrective measures or otherwise following up on the lesson for any of the documented lessons learned. For example, in response to challenges associated with assigning subject matter experts, the IRDM lessons learned document states that the program should keep resource reassignment to a minimum; however, there is no designation of who is accountable for implementation or time frame for when this solution will be followed up. IRS officials said they intend to follow up on lessons learned within the next milestone, and that each program office is responsible for ensuring that cited improvements are implemented. Without documentation of responsibilities and follow-up on lessons learned, program officials risk missing opportunities for improvement.

IRDM Developed Preliminary Performance Measures, but Needs a Plan to Ensure Necessary Data Collection and Effectiveness of Measures

IRDM planning documents list 31 preliminary performance measures for the program. IRDM has not yet committed to a final set of performance measures because, according to IRDM officials, they are determining how they will use the new information. Four of the measures are finalized. According to an IRDM plan, they expect to have some more finalized by August 2011, and others finalized by December 2011.⁶²

⁶¹A project milestone is an executive management decision point placed at a natural breakpoint in the life cycle. IRS, *Internal Revenue Manual*, Section 2.16.1 [Enterprise Lifecycle Guidance](#).

⁶²These four measures were finalized as part of the Exhibit 300 process. The Exhibit 300 is a document required by Office of Management and Budget to support information technology projects. It includes the project's desired outcome and budget justification.

A prior assessment we did of program implementation at IRS emphasizes the importance of developing evaluation plans prior to full project implementation in order to ensure that the data necessary for evaluation are collected in an efficient and timely way.⁶³ Developing a written plan, including tasks to be completed, is an important step in assuring that necessary systems and resources are available for timely data collection. Although IRDM has identified dates on which to begin collecting performance measure data, officials did not provide a plan to develop and finalize the measures. If measures are not developed early, program managers run the risk that the necessary data for evaluation cannot be collected, which could limit the potential for meaningful performance management. Although developing measures early is important to most effectively utilize performance data, we recognize that measures may evolve over time and that the process to develop the measures may be challenging.

The preliminary IRDM performance measures demonstrate two attributes of effective performance measures as identified in our prior work.⁶⁴ For example, successful performance measures are linked with the agency's goals and mission. The IRDM measures are linked to an IRDM strategy and outcome, as well as to IRS goals. Successful performance measures should also be designed, where appropriate, to meet a numerical goal and have an office or individual accountable for meeting that goal. Almost all of the IRDM measures are quantifiable and IRDM plans assign each measure to an organization that will be responsible for collecting and analyzing data, such as RAS.

IRDM has not fully documented its preliminary performance measures, making it difficult to determine whether the measures meet other attributes of successful performance measures. IRS could further leverage IRDM performance measures by incorporating additional key attributes of successful performance measurement into IRDM plans. For example, the current list of measures does not contain definitions for each measure. One proposed performance measure is "taxpayer satisfaction for the Business Master File system," but no details are provided on how taxpayer

⁶³GAO, *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved*, [GAO-04-287](#) (Washington, D.C.: Jan. 20, 2004).

⁶⁴GAO, *Tax Administration: IRS Needs to Further Refine Its Tax Filing Season Performance Measures*, [GAO-03-143](#) (Washington, D.C.: Nov. 22, 2002).

satisfaction will be gauged or used.⁶⁵ It is unclear from this description what data IRS will be assessing and how the data will be interpreted. IRDM plans should clearly state the name and include a description of each measure that is consistent with the methodology that will be used to calculate it.

IRDM planning documents do not explain how the preliminary measures were developed. Well-designed evaluation plans should be properly documented and consider the kind of information to be acquired, the sources of information, the methods to be used for sampling from data sources and for collecting information, the timing and frequency of information collection, and the basis for comparing outcomes.⁶⁶ IRDM has a framework and process for how performance measures should be defined, how to describe scope, data sources, methodology, and data reliability. IRDM has implemented some elements of their plan for some of the preliminary measures. For example, six of the performance measures have documentation that includes methodology. However, IRDM does not identify how baseline data for any of the measures will be collected.

In addition to measuring the outcomes of IRDM, performance data are needed to contribute to IRS's planned efforts to measure whether cost basis and transaction settlement reporting increases revenue and voluntary compliance, and therefore decreases the tax gap. As of May 2011, IRDM officials have identified one preliminary performance measure to capture the effect of the legislation on revenue, and one preliminary measure of voluntary compliance.⁶⁷ According to IRS officials, it will be challenging to isolate the effects of the legislation on both revenue and voluntary compliance and they have not yet determined how this will be done. In particular, as of December 2010, they noted the challenges of taking into account other factors that are not easily measured. For example, when attempting to measure the effect of the legislation on voluntary compliance, it may be difficult for researchers to account for a taxpayer who, for example, fails to accurately report capital gains from

⁶⁵Business Master File is an IRS database that holds information from business filers.

⁶⁶GAO-01-1008G; GAO, *Designing Evaluations*, GAO/PEMD 10.1.4 (Washington, D.C.: March 1991).

⁶⁷The two measures are "Increase in average gross receipts due to new Tax Gap Legislation (taking into account other contributing factors)" and "Number of additional business returns filed due to new Tax Gap Legislation (taking into account other contributing factors)."

non-securities investments in an effort to offset reporting the capital gains identified on the new information returns. IRS officials have said RAS is working on how to capture changes in compliance behavior in response to the new information reporting requirements.

Conclusions

The two new information returns have the potential to improve taxpayer compliance. The new IRDM program could enhance IRS's ability to use these and other information returns and more precisely target resources for compliance, thereby reducing the tax gap. Opportunities for improvement exist in IRDM that could help the program achieve these goals. For example, documenting IRDM coordination with related servicewide projects can help prevent inefficiencies and duplicated efforts. In addition, reliable cost estimates can help ensure that funding levels match the program's needs. Moreover, clearly documenting the assumptions and methodology for data used to inform planning decisions, such as form volume projections, can support reliable decision making.

IRS and the cost basis and transaction settlement industries had just over 2 years to implement the reporting requirements, which made timely communication from IRS critical. Incomplete information about the regulations, forms, and guidance for the new requirements could adversely affect the quality of data provided by the industries and undermine efforts to identify noncompliance. IRS made a noteworthy effort to communicate with industry. However, IRS could adopt additional communication approaches.

Performance management provides a means to evaluate program outcomes, identify improvement opportunities, and maintain accountability. Lessons learned, which are identified at the end of each IRDM milestone, provide ongoing opportunities to enhance the program. It is important that IRS document its plans to follow up on these lessons so that improvements are implemented. Further, to the extent possible, IRS should ensure that its performance measures for IRDM have the attributes of effective measures and that procedures to collect data are timely developed. A plan to establish and implement IRDM's performance measures would allow IRDM to move forward with fully documenting the methodology and data sources needed to measure the impact of the IRDM program.

Recommendations for Executive Action

To improve implementation of cost basis and transaction settlement reporting, we recommend that the Commissioner of Internal Revenue take the following seven actions:

1. Document in IRDM plans any coordination between IRDM and the *Workforce of Tomorrow* and Nonfiler Strategy projects. IRS should develop procedures or requirements to incorporate in IRDM planning documents the integration between IRDM and any other servicewide projects which could affect IRDM.
2. For future updates to MITS's IRDM cost estimate, ensure that the revised estimate is developed in a manner that reflects the four characteristics of a reliable estimate discussed in this report.
3. Clearly document the assumptions and rationale for Form 1099 volume projections used in resource planning decisions, and consult with RAS when developing projections.
4. Work with Treasury to share with the public its plans and expected release dates for IRDM regulations and formal guidance. IRS could consider including information similar to what is posed on the Department of Transportation's or the Financial Industry Regulatory Authority Web sites. IRS should also include other pertinent information regarding IRDM implementation, such as upcoming informal guidance, including FAQs, upcoming outreach, and description of the letter ruling process.
5. For future releases of new or significantly revised forms, whenever possible, release draft instructions to facilitate the most useful comments.
6. Document a plan to assign responsibility and establish a procedure to follow up on the lessons learned identified after each milestone phase.
7. Develop a plan to establish and implement IRDM performance measures. The plan should include documentation of the process and rationale for developing and using IRDM performance measures, including information such as the methodology, data sources, and targets, in order to establish that the performance measures have the necessary attributes of efficient measures.

Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of Internal Revenue for his review and comment. We received written comments from the Deputy Commissioner for Services and Enforcement, which are reprinted in appendix V. IRS also provided us with technical comments, which we incorporated into the report as appropriate.

IRS said it has taken actions consistent with our recommendations to improve its implementation plans. Of our seven recommendations, IRS

explicitly agreed with three; without explicit agreement, described steps it is taking to address two; agreed in principle with another; and neither agreed nor disagreed with a final recommendation.

IRS explicitly agreed with our recommendations regarding its cost estimate, form volume projections, and lessons learned. In agreement with the recommendation to ensure that a revised MITS IRDM cost estimate reflects GAO's four characteristics of a reliable estimate, IRS said it intends to update the estimate in a manner consistent with the *GAO Cost Estimating and Assessment Guide*. In response to our recommendation to clearly document the assumptions and rationale for Form 1099 volume projections, IRS agreed that additional documentation for the 125 million projection would have been helpful. IRS said that RAS will provide updated estimates for use in decision making, and that it will continue to consult with RAS when developing and documenting projections. IRS also agreed to assign responsibility and establish a procedure to follow up on lessons learned. In its response, IRS said it has taken steps to improve lessons learned reports by assigning responsibility and due dates for each lesson, which will facilitate their periodic review.

While not directly saying if it agreed with our recommendation on documenting coordination between IRDM and servicewide projects, IRS said it has taken steps to document coordination in the *IRDM Strategic Roadmap*. Similarly, in response to our performance measurement recommendation, IRS said that it will fine tune its current performance measurement plan by drafting definitions for IRDM's performance measures and will include methodology, data sources, and targets to ensure all necessary attributes of performance measures are captured.

IRS agreed in principle with our recommendation to, whenever possible, release draft instructions of new or significantly revised forms. Recognizing the value of obtaining feedback on draft instructions, IRS said that it strives to release draft instructions as quickly as possible, but needs to release forms early so that software developers and IRS technology specialists can begin programming activities. We agree it is not always possible to release draft instructions with new or revised forms, but doing so whenever possible can help stakeholders ensure that the data reported on such forms are appropriate and also help minimize the burden of developing systems to report data to IRS.

IRS did not explicitly agree or disagree with our recommendation that it share, with the public, plans and expected release dates for IRDM outreach, regulations, and formal and informal guidance. IRS agreed that

continuous engagement of stakeholders is important and highlighted that its Web site contains information reporting guidance, which IRS staff are available to discuss. However, IRS said that it cannot accurately predict release dates for formal guidance published in the *Federal Register* or Internal Revenue Bulletin. IRS counsel told us this was because Treasury reviews formal guidance, including regulations. IRS also said, as we note in our report, that IRDM guidance projects were listed in an annual Priority Guidance Plan published by IRS and Treasury. However, the plan only lists projects to be completed in the coming year, without more specific projected release dates and, for cost basis and transaction settlement reporting, the plan provides information on regulations but not guidance and outreach. We recognize that predicting release dates is difficult. In a Web-based environment IRS could both note this uncertainty and change estimated dates as necessary. Using the IRS Web site to post expected release dates for outreach, regulations, and guidance would help external stakeholders anticipate IRS actions and plan their implementation of the laws.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We will also send copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. Copies are also available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staffs have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9039 or brostek@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff members who made major contributions to this report are listed in appendix VI.



Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

To address the four objectives of this report, we focused on the Information Reporting and Document Matching (IRDM) program because it is the program responsible for implementing cost basis and transaction settlement reporting.

To assess IRS's implementation plans for the new requirements, we compared the Internal Revenue Service's (IRS) plans, such as the *IRDM Strategic Roadmap* and the *IRDM Program Management Plan*, to criteria from prior GAO reports, the *Internal Revenue Manual*, and other sources.¹ When possible, we looked for evidence of IRS following its plans, but we did not broadly evaluate whether these plans and actions are contributing to the program's goals of increasing compliance. Because most components of IRDM were still being developed, we used dates in IRDM planning documents to gauge whether established time frames had been met and IRS was meeting planned time frames. To assess IRS's cost estimates to implement the new requirements, we compared IRS cost estimates and budget plans for the implementation with GAO's cost estimating criteria.² To determine to what extent the estimate adheres to the characteristics of a high-quality cost estimate, we evaluated the Modernization and Information Technology Services (MITS) division's IRDM life-cycle cost estimate to assess whether it met key characteristics identified in the *GAO Cost Estimating and Assessment Guide*. Our guide, which is based on extensive research of best practices for estimating program schedules and costs, indicates that a high-quality, valid, and reliable cost estimate should be well documented, comprehensive, accurate, and credible. We analyzed the cost estimating practices used by MITS against these best practices to determine whether the IRDM cost estimate is comprehensive, accurate, well-documented, and credible. We then characterized the extent to which each of these four characteristics of reliable cost estimates were met; that is, we rated each characteristic as being either: Met, Substantially Met, Partially Met, Minimally Met, or Not Met. To do so, we scored each of the individual key practices associated

¹Criteria were developed from sources such as: GAO, *Results-Oriented Cultures: Implementation Steps to Assist Mergers and Organizational Transformations*, [GAO-03-669](#) (Washington, D.C.: July 2003); GAO, *Internal Control Management and Evaluation Tool*, [GAO-01-1008G](#) (Washington, D.C.: August 2001), Carnegie Mellon University Software Engineering Institute, *Capability Maturity Model Integration for Development (Capability Maturity Model Integration for Development)*; the *Internal Revenue Manual Exhibit 1.5.1-5*, and [Section 2.16.1](#).

²GAO, *Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, [GAO-09-3SP](#) (Washington, D.C.: Mar. 9, 2009).

with cost and scheduling best practices on a scale of 1-5 (Does not meet = 1, Minimally Meets = 2, Partially Meets = 3, Substantially Meets = 4, and Meets = 5), and then averaged the individual practice scores associated with a given best practice to determine the overall rating. We shared our cost guide, the criteria against which we evaluated the program's cost estimates, as well as our preliminary findings with program officials. We then discussed our preliminary assessment results with IRDM officials and cost estimators. When warranted, we updated our analyses based on the agency response and additional documentation provided to us.

To determine the extent to which IRS has issued timely regulations and guidance and undertaken outreach efforts, we interviewed IRS officials in the Office of Chief Counsel about the rulemaking process for both laws. We analyzed the timing of the regulations and communication from IRS relative to the enactment dates and effective dates of both laws. In order to identify key issues, we examined the comment letters IRS received in response to the proposed regulations for both laws. We also reviewed the *Stakeholder Management and Communication Plan*, which is a plan developed by IRDM to manage communication with industry and other stakeholders. We met with representatives of the Information Reporting Program Advisory Committee (IRPAC), an IRS advisory group made up of tax professionals, as well as four private industry groups which represent companies that will be required to file information returns under the new cost basis and transaction settlement provisions; the Electronic Transactions Association (ETA), which represents the payment card industry and third-party payment networks; the Securities Industry and Financial Markets Association (SIFMA); the Financial Information Forum (FIF), which represents the financial technology industry; and the Investment Company Institute (ICI), which represents the mutual fund industry to discuss their communications with IRS and possible data quality issues.

To examine how IRS will use the new returns to improve compliance, and the possible effects of the implementation, we examined IRS plans depicting the future information technology systems and IRDM business processes for using information returns in compliance efforts, and discussed the plans with IRS officials.³ To gauge whether IRS plans

³Including the Integrated IRDM End-to-End High Level To-Be Process Flow diagram.

consider potential data accuracy issues, we compared IRDM plans for using the new data to GAO criteria for controlling data quality.⁴

To analyze IRS's plans to assess the implementation process, we reviewed the existing lessons learned documentation. To determine IRS's plans to assess program outcomes, we reviewed the preliminary performance measures found in documents such as the IRDM *Program Management Plan* and the IRDM *Strategic Roadmap*. To the extent possible, we assessed the preliminary measures against GAO's performance measurement and program evaluation criteria.⁵ We also interviewed IRS officials from the Research Analysis and Statistics (RAS) division to identify efforts made to develop performance measures and measure the outcome of the program.

For each objective, we shared our assessment criteria with IRS officials, who agreed with their relevance. We also interviewed IRS officials in the Small Business/Self Employed (SB/SE) division, MITS, and Forms and Publications. We gave IRS officials an interim briefing on some of the findings in this report. Our work was done mainly at IRS Headquarters in Washington, D.C. and its division office in New Carrollton, Maryland, where the officials responsible for implementing the information returns programs were located. To assess the reliability of the cost estimate data that we used to support findings in this report, we reviewed relevant program documentation, such as cost estimation spreadsheets and a report explaining the estimate, to substantiate evidence obtained through interviews with knowledgeable agency officials, where available. We found the data we used to be sufficiently reliable for the purposes of our report. We also made appropriate attribution indicating the sources of the data.

We conducted this performance audit from June 2010 through May 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence

⁴GAO, *Internal Control Management and Evaluation Tool* [GAO-01-1008G](#) (Washington, D.C.: August 2001).

⁵Criteria were developed from sources such as GAO, *Tax Administration: IRS Needs to Further Refine Its Tax Season Performance Measures*, [GAO-03-143](#) (Washington, D.C.: Nov. 22, 2002).

obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Changes to Cost Basis Tracking and Calculations

Table 4 identifies six changes to reporting requirements affecting both brokers and issuers of stock. These changes were highlighted in comment letters submitted by industry in response to proposed regulations. Prior to the legislation, brokers were required to provide some information, including gross sales of securities, to the Internal Revenue Service (IRS) on the Form 1099-B. The new legislation requires that in addition to this information, brokers are responsible for reporting adjusted cost basis information and whether a gain or loss is long term or short term. Major changes to reporting requirements can be categorized as either a *tracking* change or a *calculation* change. The tracking rules allow brokers to track events affecting the basis amount of a security over the period of ownership and to pass that information among other brokers, IRS, and taxpayers. The calculation rules instruct brokers on which of the various methodologies should be used to calculate basis and when to take into account other tax rules that affect basis.

Table 4: Selected Changes to Tracking and Calculating Basis for Reporting Resulting from the Energy Improvement and Extension Act of 2008

Type	Change to cost basis reporting requirement
Tracking	Cost Basis: Although brokers have previously been responsible for reporting gross sales to IRS and taxpayers through the Form 1099-B, brokers are now also responsible for tracking and reporting cost basis information.
	Transfer Statements: Transferring broker is required to transfer cost basis to new broker within 15 days of the transfer and is given a penalty for failure to do so.
	Issuer Actions: Issuer is required to file or publish corporate action information within 45 days.
	Gifted and Inherited Securities: For gifted securities, brokers are required to report fair market value and/or carryover basis; for inherited securities, brokers are required to report fair market value at date of death.
Calculation	Basis Calculation Method: There are now default calculations for cost basis that are determined by type of security, broker default methods and/or taxpayer election.
	Adjustment to Basis under Wash Sale Rules: Brokers are to determine adjusted basis without regard to wash sale rules unless the transactions occur in the same account with respect to identical securities.

Source: GAO analysis.

Appendix III: Assessment of MITS's IRDM Cost Estimate

We assessed the Modernization and Information Technology Service (MITS) group's Information Reporting and Document Matching (IRDM) program cost estimate to determine the extent to which it meets best practices established by the *GAO Cost Estimating and Assessment Guide*.¹ We found that the cost estimate meets one, substantially meets three, partially meets nine, minimally meets four, and does not meet two best practices.² Table 5 shows the extent to which the MITS IRDM Cost Estimate meets practices.

Table 5: MITS IRDM Cost Estimate Alignment with Best Practices

Best practices characteristics	Overall assessment	Characteristics of MITS's IRDM cost estimate (assessment of whether best practices met)
<p>A comprehensive cost estimate:</p> <ul style="list-style-type: none"> • includes all life-cycle costs;^a • completely defines the program, reflects the current schedule, and is technically reasonable; • has a product-oriented work breakdown structure,^b traceable to the program's technical scope, at an appropriate level of detail; and • documents all cost-influencing ground rules and assumptions.^c 	<p>Substantially meets best practices for a comprehensive cost estimate.</p>	<ul style="list-style-type: none"> • Covers most life-cycle costs but not the system's eventual retirement. (<i>Substantially meets.</i>) • Provides technical descriptions for each project phase, but doesn't reflect schedule changes. (<i>Substantially meets.</i>) • Has a work breakdown structure that breaks down the end product and outlines the major work but has not been updated. (<i>Substantially meets.</i>) • Lists ground rules and assumptions, but doesn't provide historical data to support the assumptions and only considers the impact of risks on a portion of the estimate. (<i>Partially meets.</i>)

¹GAO, *GAO Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, GAO-09-3SP (Washington, D.C.: Mar. 9, 2009).

²We rated the extent to which IRS met each best practice on the following scale: "Meets," IRS provided complete evidence that satisfies the entire criterion; "Substantially meets," IRS provided evidence that satisfies a large portion of the criterion; "Partially meets," IRS provided evidence that satisfies about half of the criterion; "Minimally meets," IRS provided evidence that satisfies a small portion of the criterion; and "Does not meet," IRS provided no evidence that satisfies any of the criterion.

**Appendix III: Assessment of MITS's IRDM
Cost Estimate**

Best practices characteristics	Overall assessment	Characteristics of MITS's IRDM cost estimate (assessment of whether best practices met)
<p>A well documented cost estimate should:</p> <ul style="list-style-type: none"> • capture the source data used, the reliability of the data, and how the data were made compatible with other data in the estimate; • describe the calculations and the methodology used to derive each element's cost; • describe how the estimate was developed; • discuss the technical baseline description;^d and • provide evidence of management review and acceptance. 	<p>Partially meets best practices for a well documented cost estimate.</p>	<ul style="list-style-type: none"> • Does not contain many details about the data used. <i>(Minimally meets.)</i> • Cost calculations were based on expert judgment as well as a model that accounts for software development, testing, quality assurance, and other factors, but the calculations themselves are not shown. <i>(Partially meets.)</i> • Contains a narrative about the program and cost tables, and shows results of cost calculations, but does not discuss risk or show formulas used in calculations. <i>(Partially meets.)</i> • Provides technical descriptions for each project piece. <i>(Meets.)</i> • Documents a management briefing which contains the project and technical information, but lacks risk information, ground rules, assumptions, and evidence of management acceptance. <i>(Partially meets.)</i>
<p>An accurate cost estimate:</p> <ul style="list-style-type: none"> • produces unbiased results; • is properly adjusted for inflation; • contains few mistakes; • is regularly updated to reflect significant program changes; • documents and explains variances between planned and actual costs; and • reflects cost estimating experiences from comparable programs. 	<p>Partially meets best practices for an accurate cost estimate.</p>	<ul style="list-style-type: none"> • Shows a 60-70 percent confidence level for project cost, but does not show a confidence level for operations cost or the cost estimate as a whole, and does not show how the confidence level was calculated. <i>(Partially meets.)</i> • The estimate is in constant 2011 dollars. MITS does not adjust cost estimates for inflation because inflation is included during the budget process. <i>(Partially meets.)</i> • Though few numbers and equations are presented, the numbers shown are all accurate. <i>(Partially meets.)</i> • IRS does not plan to update the cost estimate. Instead, IRS updates the Exhibit 300 (E-300) annually. <i>(Partially meets.)</i> • As of April 2011, IRS is developing a process to compare its cost estimates to actual costs. <i>(Minimally meets.)</i> • Uses a model based on a database of historical costs, but documentation was not adequate to assess how the model was used and whether it was calibrated properly. <i>(Partially meets.)</i>

**Appendix III: Assessment of MITS's IRDM
Cost Estimate**

Best practices characteristics	Overall assessment	Characteristics of MITS's IRDM cost estimate (assessment of whether best practices met)
<p>A credible cost estimate includes:</p> <ul style="list-style-type: none"> • a sensitivity analysis that identifies a range of possible costs based on varying inputs;^e • a risk and uncertainty analysis;^f • cross-checking of major cost elements; and • an independent cost estimate conducted by another organization. 	<p>Minimally meets best practices for a credible cost estimate.</p>	<ul style="list-style-type: none"> • Contains no evidence that a sensitivity analysis was performed. <i>(Does not meet.)</i> • Contains a risk analysis for the project costs only. However, it is unclear how this analysis was done. <i>(Partially meets.)</i> • IRS uses a rule of thumb that operations costs are 50 percent greater than non-recurring costs, but there was no evidence that other cross-checks were performed. <i>(Minimally meets.)</i> • An independent cost estimate was not performed. <i>(Does not meet.)</i>

Source: GAO analysis of MITS IRDM cost estimate documents.

^aA life-cycle cost estimate provides a complete and structured accounting of all resources and associated cost elements required to develop, produce, deploy, and sustain a particular program.

^bA work breakdown structure defines the work necessary to accomplish a program's objectives. It is product-oriented if it allows a program to track cost and schedule by defined deliverables, such as a hardware or software component.

^cGround rules are a set of estimating standards that provide guidance and minimize conflicts in definitions, while assumptions are judgments about past, present, or future conditions that may affect the estimate.

^dA technical baseline description provides a common definition of the program, including detailed technical, program, and schedule descriptions of the system, for a cost estimate to be built on.

^eA sensitivity analysis examines how changes to key assumptions and inputs affect the estimate.

^fA risk and uncertainty analysis recognizes the potential for error and attempts to quantify it.

Appendix IV: IRS's Planned Use of Cost Basis and Transaction Settlement Data

Table 6 lists the years that the Internal Revenue Service (IRS) expects to have key Information Reporting and Document Matching (IRDM) capabilities in place. Each year, IRDM is expected to increase in functionality, for both individual and business data.

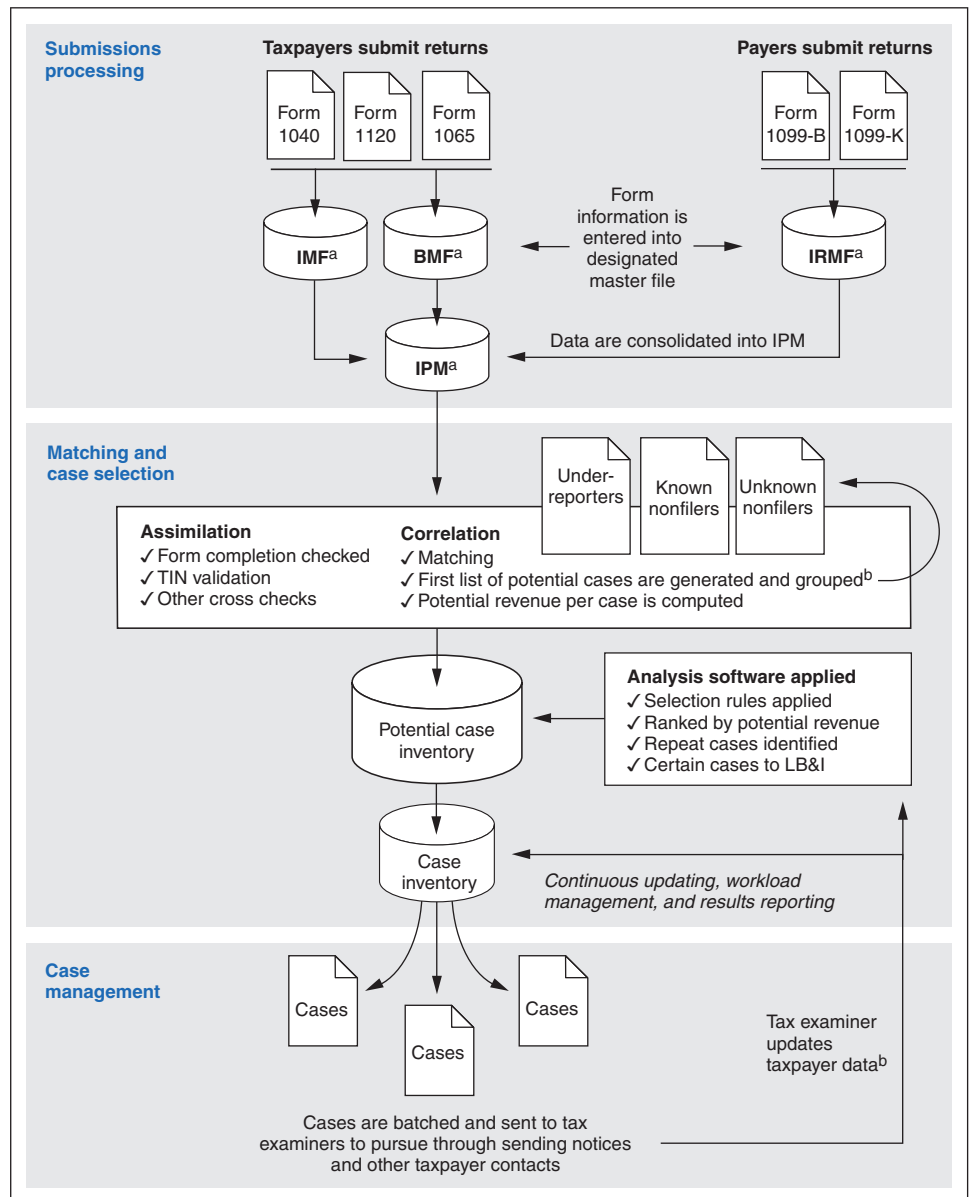
Table 6: Key Planned IRDM Capability Enhancements for Matching Documents, Identifying Cases, and Managing Cases Beginning in 2012

2012	2013	2014 and beyond
<ul style="list-style-type: none"> Begin matching for calendar year business filers; use new technology for individual return matching. 	<ul style="list-style-type: none"> Expand matching to include business taxpayers on a fiscal year schedule, and flow through entities. 	<ul style="list-style-type: none"> Use statistical tools to segment business cases by industry, type of return, preparer, etc.
<ul style="list-style-type: none"> Designate type of case, such as nonfiler, for business taxpayers. 	<ul style="list-style-type: none"> Summarize initial data on taxpayer compliance behavior. 	<ul style="list-style-type: none"> Summarize enhanced data on taxpayer compliance behavior.
<ul style="list-style-type: none"> Use statistics and analytic technology for individual and business case selection. 	<ul style="list-style-type: none"> Collect feedback on analytic technology and refine case management accordingly. 	<ul style="list-style-type: none"> Use statistics and analytic technology for nonfiler case management.
<ul style="list-style-type: none"> Begin using automation for computation of owed taxes, and for case management for calendar year business filers. 	<ul style="list-style-type: none"> Expand the use of automation to generate taxpayer notices, and for case management for fiscal year and flow through entities. 	<ul style="list-style-type: none"> Use matching data to send taxpayer notices earlier.
<ul style="list-style-type: none"> Collect feedback on cases worked to refine the matching programs and case selection. 		<ul style="list-style-type: none"> Create virtual case files.

Source: GAO analysis of IRDM planning documents.

Figure 3 provides an overview of how, once implemented, IRDM will process and match information return data, and manage cases. Differences between IRS's existing system for processing information returns and the anticipated IRDM systems are described earlier in this report in table 3.

Figure 3: IRDM's Planned End-State for Using Cost Basis and Transaction Settlement Data



Source: GAO analysis of IRS information.

^aThe figure represents IRDM functions, with the exception of the Integrated Production Model (IPM), a database of taxpayer information which is being developed by another Modernization and Information Technology Services (MITS) program. Other databases involved in this system are the individual master file (IMF), the business master file (BMF), and the information returns master file (IRMF).

^bAt these points in the process, updated information on the taxpayer is sent to the appropriate Master File(s).

Submissions Processing

Tax returns are submitted to IRS, and data from the forms are transmitted to the appropriate account master file. A master file contains tax data and related information pertaining to certain forms or taxpayers; the IMF contains data on individuals, the BMF contains data on business income taxpayers. Information returns are submitted to IRS through the Web-based Filing Information Returns Electronically system and, eventually, transmitted to the IRMF. This process will be same as before IRDM was implemented. Master file data are then consolidated into the IPM database.

Matching and Case Selection

Tax and information return data go through the assimilation process, which does basic checks on the forms to identify basic errors such as blank boxes on returns, or invalid Taxpayer Identification Numbers (TIN). If a TIN is determined to be incorrect, IRS contacts the payer who must check the TIN with records and attempt to correct the information return, which may include notifying the taxpayer. If the issue is not resolved, the payer must begin backup withholding. Next, correlation—or matching—is done to identify discrepancies between the BMF or IMF, and IRMF data. Under IRDM, for the first time, IRS will be matching BMF data to the IRMF. The matching results in a first list of potential cases, that are grouped as underreporters or nonfilers. For each potential case, a revenue estimate for the case is calculated, and the master files are updated to indicate a mismatch. The potential case list is further refined when statistical software and criteria for selecting the cases with the postrevenue potential are applied. IRDM will allow for more frequent updates of these criteria and for information from prior cases to inform the case selection process, which results in a final case list. Certain cases are sent to Large Business and International division, Examination, or other functions.

Case Management

Cases are batched and given to tax examiners for a manual review, and master files are updated. Based on the review, the taxpayer may receive notices from IRS asking for explanations of discrepancies between income reported on their tax return and the information return. In initial years of IRDM, notices for business taxpayers will be generated by a tax examiner or other staff; eventually those notices will be generated automatically based on a tax examiner's case review. Depending on the taxpayer's response, a case could be resolved.

Appendix V: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

May 9, 2011

Mr. Michael Brostek
Director, Tax Issues
U.S. Government Accountability Office
Washington, DC 20548

Dear Mr. Brostek:

Thank you for the opportunity to review the Government Accountability Office (GAO) draft report titled, "Information Reporting: IRS Could Improve Cost Basis and Transaction Settlement Reporting Implementation" (Job Code 450854). Information reporting is essential to taxpayers' voluntary compliance and ensuring appropriate filing and use of these new information returns is an important responsibility of the Internal Revenue Service (IRS). We recognize the importance of these provisions and the impact they will have on compliance.

The efforts of the Information Returns Document Matching (IRDM) Program have been extensive and innovative. We appreciate GAO's acknowledgment of the implementation planning and structure. We established the IRDM governance structure which includes executives at the highest level and follows project management disciplines to ensure due diligence in the ongoing management of this program. We engaged impacted stakeholders in the development of the regulations and forms.

Consistent with GAO's recommendations, we have taken actions to improve our implementation plans and continue to progress through our milestones in a timely manner to ensure we are prepared to receive and use the data on the new information returns. We have addressed these improvements and provided additional comments that specifically address each of your recommendations in a separate enclosure.

If you have any questions, please contact me, or a member of your staff may contact Faris Fink, Commissioner, Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,

A handwritten signature in black ink, appearing to read "S. T. Miller".

Steven T. Miller
Deputy Commissioner for Services and Enforcement

Enclosure

Enclosure

GAO Recommendations and IRS Responses to GAO Draft Report
Information Reporting: IRS Could Improve Cost Basis and Transaction Settlement
Reporting Implementation
GAO-11-557

Recommendation:

Document in IRDM plans any coordination between IRDM and the Workforce of Tomorrow and Nonfiler Strategy projects. IRS should develop procedures or requirements to incorporate in IRDM planning documents the integration between IRDM and any other servicewide projects that could affect IRDM.

Comments:

IRDM considered many internal stakeholders in planning for implementation, including support organizations such as Human Capital Office (HCO) and Agency-Wide Shared Services (AWSS) who shepherd the processes for hiring and training associated with Workforce of Tomorrow initiatives. Since these initiatives are being built into IRS hiring and training plans, they will automatically be employed as part of the embedded support. Likewise, IRDM is represented in Servicewide Non-Filer Strategy efforts and IRDM staff recently briefed the Non-Filer Executive Advisory Council on the IRDM objectives as they relate to Non-Filers.

We have taken steps to document coordination between IRDM and IRS initiatives in our Strategic Roadmap and will continue to update planning documents as appropriate going forward.

Recommendation:

If MITS IRDM cost estimate is redone, ensure that the revised estimate is developed in a manner that reflects the four characteristics of a reliable estimate as discussed in the GAO report.

Comments:

We concur that any revised estimate should be developed in a manner that is consistent with the GAO Cost Estimating and Assessment Guide. Strategy and Planning intends to update the estimate as we believe that it will be beneficial for the agency to collect and model the project attributes and use the results to help refine future estimates.

Recommendation:

Clearly document the assumptions and rationale for Form 1099 volume projections used in resource planning decisions, and consult with RAS when developing projections.

2

Comments:

During the audit period, we supplied GAO with three projections. The first projection, the information from December 2005 (updated March 2006), reflects a projected costing to implement a legislative proposal. We agree that additional documentation for the calculation would have been helpful.

Procuring system hardware to support the growth in filings requires significant lead time. Therefore, the initial volume projections for additional information returns were developed early on to plan for systems capacity. These projections were used to size equipment and systems, and they represent the potential maximum volume in information return receipts that can be accommodated.

Research Analysis Statistics (RAS) Office of Research developed the most recent estimate as a starting point for workload planning and to develop approximate mean expected volumes. The Office of Research will update the estimates for staffing and logistical considerations. We will continue to consult with RAS when developing projections and document the methodology, assumptions, and rationale for the projections.

Recommendation:

Work with Treasury to share with the public its plans and expected release dates for IRDM regulations and formal guidance. IRS could consider including information similar to what is posted on the Department of Transportation's or Financial Industry Regulatory Authority websites. IRS should also include other pertinent information regarding IRDM implementation, such as upcoming informal guidance, including FAQs, upcoming outreach, and description of the letter ruling process.

Comments:

We agree that continuous engagement of external stakeholders is important. We established a page on IRS.gov to collect formal published and informal written guidance about our information reporting projects. Our published guidance includes contact names and telephone numbers, and these individuals are available during normal business hours to assist persons who may have questions about the guidance we publish.

Before we publish guidance in the Federal Register or the Internal Revenue Bulletin, we publish an annual Priority Guidance Plan on IRS.gov, which we update periodically, informing the public of the guidance projects, including IRDM projects that the Department of Treasury and the IRS intend to publish during the current plan year. We do not include expected release dates for these guidance projects, including

IRDM projects, because accurate release dates cannot be predicted. Finally, we publish a description of the letter ruling process annually in the first revenue procedure we publish each year. This revenue procedure, which is available in the Internal Revenue Bulletin and on IRS.gov includes, among other things, an up-to-date list of subjects on which the IRS will not rule.

Recommendation:

For future releases of new or significantly revised forms, whenever possible, release draft instructions to facilitate the most useful comments.

Comments:

We agree with this recommendation in principle. While our practice is to release instructions as quickly as possible, the overriding priority in supporting taxpayers and practitioners is the early release of forms so that software developers and IRS information technology specialists can begin programming activities. This often precludes the simultaneous release of forms and instructions. We do, however, recognize the importance of obtaining meaningful feedback from our customers and strive to provide draft instructions for new or substantially revised forms as soon as and whenever possible.

Recommendation:

Document a plan to assign responsibility and establish a procedure to follow-up on lessons learned identified after each milestone phase.

Comments:

We agree with this recommendation. The IRDM staff has taken steps to improve the usefulness of the Lessons Learned Reports by assigning responsibility for each lesson learned, along with due dates for status reporting. These assignments are included in the Lessons Learned Report for simplified tracking and follow up, and a periodic review of the lessons learned will occur on a regular basis. In addition, the IRDM staff will work with the MITS Lessons Learned process owners to implement similar improvements to the enterprise level artifacts and processes.

Recommendation:

Develop a plan to establish and implement IRDM performance measures. The plan should include documentation of the process and rationale for developing and using IRDM performance measures, including information such as the methodology, data sources, and targets to establish that the performance measures have the necessary attributes of efficient measures.

4

Comments:

Our Performance Measurement Plan includes a plan of action, milestones, and dates. We shared our plan with GAO. We are drafting a dictionary with definitions for the data and measures. Many of the measures are patterned after Individual Master File (IMF) returns and definitions need to be modified to fit with Business Master File (BMF) returns. As needed, we will fine-tune the methodology, data sources, and targets for performance measurement to ensure all necessary attributes are captured.

Appendix VI: GAO Contacts and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9039, or brostekm@gao.gov

Staff Acknowledgments

In addition to the contact named above, Libby Mixon, Assistant Director; Laurel Ball; Mary Coyle; Jennifer Echard; Ioan Ifrim; Donna Miller; Cynthia Saunders; Stacey Steele; A.J. Stephens; and Lindsay Welter made key contributions to this report.

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