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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D. C. 20548

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STATEMENT OF
WILLIAM J. ANDERSON, DIRECTOR
GENERAL GOVERNMENT DIVISION,
BEFORE THE
SUBCOMMITTEE ON COMMERCE, CONSUMER AND MONETARY AFFAIRS
HOUSE COMMITTEE ON GOVERNMENT OPERATIONS
ON ^{the} ₄ IRS DOCUMENT MATCHING PROGRAM]

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Mr. Chairman:

We welcome the opportunity to assist your Subcommittee in its continuing deliberations on how to improve the IRS' document matching program. You and your Subcommittee have been most active in stimulating improvements in this program, and we are glad to share our thoughts with you.

This Subcommittee has long recognized the importance of the document matching program as well as the need to improve it and expand its coverage. Thus, in its September 23, 1976, report, the Subcommittee pointed out that document matching is the only systematic program for identifying those taxpayers who do not report all their income, who do not file a return, or who are unaware that they are entitled to a refund. The Subcommittee's recommendations included (1) setting a 1980 target date for expanding matching to all documents filed, including those filed on paper and those from foreign sources; (2) expanding magnetic tape reporting for information returns; and, (3) strengthening the penalty program for those who fail to provide an identifying Social Security Number. At that time, the Subcommittee also recommended that adequate funding be provided by the Congress. Subsequent to that report, the Subcommittee has been instrumental in following-up on many of its recommendations and in identifying additional problems.

As we show in Attachment I to this statement, payers of wages, interest, dividends and 16 other types of payments are required to report such payments to the IRS. Using its computers, IRS can then match these payments to income reported by taxpayers on their tax returns.

Since 1974, IRS has made considerable progress toward achieving a full matching program, but many problems still need to be solved. For example, opportunities exist in the areas of improving payer compliance, using all documents received, expanding the program, and improving the computer operations.

Referring again to Attachment I, about 525 million information returns were filed with IRS and Social Security for tax year 1978. Of these returns, about 417 million, or 79 percent, entered the processing cycle for the matching program at IRS. Ultimately, IRS matched about 397 million returns, or 76 percent of the total received.

In the previous tax year, 1977, IRS matched only about 50 percent of the information returns it received, as shown in Attachment II. The increase to 76 percent matching for tax year 1978 can in large part be attributed to implementation of the Combined Annual Wage Reporting Program established by Public Law 94-202. Under this program, the Social Security Administration receives all wage information returns and

provides the information to IRS on magnetic tape. Through the use of optical scanning equipment, Social Security transcribes the wage returns filed on paper documents to magnetic tape. In previous years, the IRS service centers received the returns and transcribed only a sample of those filed on paper.

In 1974, the year in which the program as it now exists came into being, only 35 percent of the documents received were matched.

As you know, Mr. Chairman, the document matching program is a powerful tool for detecting on a mass scale taxpayers who under-report or do not report their income, and for putting taxes on that income into the Treasury. Other tools include collections, audits, and criminal investigations. According to IRS, as shown in Attachment III, the document matching program for fiscal year 1979 is expected to return about \$ 3.90 to the Treasury for each dollar spent. While exact figures are difficult to determine, the figure for document matching compares quite favorably with those for other tools: from \$ 3.70 to \$ 23.00 for the various collection programs and \$ 4.00 for audits. No figures are available for criminal investigations. About 70 percent of all individual tax returns filed are currently matched against at least one information document. In addition to its use in directly detecting

underreporters and nonfilers, the document matching program also provides the auditors with another means for detecting unreported income at the time a return is audited.

In spite of this progress, many problems need resolution and opportunities exist to strengthen the program. Many of these were identified in this Subcommittee's 1976 report. Nearly all were discussed by us last year before this Subcommittee and before other Subcommittees in 1979 and in this year.

Payers Do Not Submit All Documents

One of the continuing problems with the document matching program is that payers do not submit all required information documents and IRS has not yet developed the means to ensure compliance with submission requirements. For example, IRS studies have consistently shown that many Form 1099 information documents were not filed by payers. Noncompliance rates ranged from 19 to 42 percent in four such studies conducted between 1966 and 1974. More recent studies have shown similar results. Two weeks ago, we testified before another Subcommittee that the Government itself was not fully complying. Thus, we noted that the Departments of the Navy, Interior, and Energy; the General Services Administration; and the IRS itself were not in full compliance with the requirements for filing Form 1099 information documents for non-employee compensation. At that time, we identified various actions which were needed to assure that Federal agencies themselves comply with the reporting requirements.

Currently, IRS' main tools for detecting payer noncompliance are first, the "package audit" - a procedure whereby taxpayers being audited for any reason are also checked for compliance with the information return requirements - and second, "full compliance checks" in which taxpayers being pursued by the Collection Division are also checked for general compliance with other IRS requirements including those for information reporting. These checks are selective in nature and little information is available on their overall effectiveness.

IRS has undertaken actions recently which may provide the agency with the capability to detect, on a mass scale, payer non-compliance in the filing of withholding (Form W-2) information documents. Under the Combined Annual Wage Reporting Program, IRS matches end-of-year employer-provided withholding documents against the sum of employee wages and payroll taxes paid shown on their quarterly tax returns. Although the program is directed towards ensuring that employers pay the correct payroll taxes, it also makes it possible for IRS to catch payers who fail to submit all required W-2 documents except in the case where the payers made compensating errors on their quarterly tax returns.

We do not know how much noncompliance the program will detect, nor does it address the problem of verifying compliance with Form 1099 reporting requirements. IRS has, however, begun a study which

is intended to determine the potential for matching form 1096s (the transmittal documents used for submitting 1099s) against IRS' business tax return master file in order to detect noncomplying payers.

To provide better assurance that payers file the required documents, we continue to support the proposal made by Treasury last June before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means to increase the current penalty of \$1 per return with a maximum of \$1,000 per year to 5 percent of total unreported payments.

Millions of Submitted Documents
Go Unused

Many documents filed by payers are not used. For example, about 128 million of the 525 million documents received by IRS and SSA for tax year 1978 were not matched against tax returns.

Although some of the following categories overlap, the approximately 128 million tax year 1978 information returns not matched to tax returns included:

- out-of-sample non-wage returns received on paper at the IRS Service Centers (57 million);
- information returns pertaining to business tax returns (34 million);
- wage returns not processed in time by Social Security (24 million); and
- returns with invalid or missing taxpayer identification numbers (5.6 million).

IRS has sufficient computer resources to process all the returns, but says it would need additional staff and funds to transcribe the paper returns and to work the increased number of cases which would occur. For example, IRS estimated in its fiscal year 1981 budget submission that to increase the number of paper returns used from the current level to 100 percent would require an additional \$40 million, as shown in Attachment V. Transcription of paper information returns is primarily a manual process at IRS, and this estimate assumes manual transcription. There is potential, however, to improve this process through automation. Social Security uses optical scanning equipment to transcribe about 60 percent of the paper W-2 returns it receives, and we believe IRS should explore the possibility of using similar automated methods for non-wage returns. IRS should also improve its efforts to increase the number and improve the quality of returns filed on magnetic media, which do not require transcription. In this connection, we found strong indications that many large volume payers, such as banks, whose records presumably are already computerized, are not filing on magnetic media.

IRS also needs to ensure that it is effectively and economically dealing with the fact that many information documents are submitted without a taxpayer identification number or with an incorrect number. Some of these information documents are used in the matching program but

only after IRS expends effort in obtaining the correct number. No data exists to show if these efforts are cost beneficial. Even if they are, IRS should still seek improved payer reporting and needs to insure the effectiveness of its programs for accomplishing that. In this regard, we found that IRS generally does not assess penalties on payers who submit documents lacking the taxpayers' identification number.

More Income Could be Subject
To Document Matching

Because of the capability which document matching provides to identify and pursue noncompliance on a mass scale, finding ways to include more income under the program should be a key part of the agency's efforts to deal with the underreporting and nonfiling problem. IRS recognizes that there is a direct correlation between the presence of an information document and the level of compliance. Potentially, more income could be subjected to information reporting and matching. For example, most interest paid in tax year 1978 on marketable U.S. public debt obligations--Treasury bills, notes, and bonds--is not subject to information reporting. Efforts are underway to establish a "book entry" system on these bearer securities in which the purchaser's name and social security number would be recorded to help identify the recipients of interest on them. IRS has

been working with the financial community to develop some type of information reporting for this interest and that which is paid to individuals who hold other (nongovernment) bearer-type securities.

Sources other than the information documents now used in the matching program could also be used for matching income paid to the taxpayer's return. For example, IRS is researching the feasibility of obtaining and matching State tax refund data. Other surrogate information documents may also be available. For example, a 1040 return containing an alimony deduction could possibly be used to determine if the recipient reported the alimony as income. IRS now relies on its audit program to detect noncompliance in these areas. It can, however, audit only a limited number of returns.

Computerized Operations Could Be
More Efficient and Effective

As described in our forthcoming report on IRS' computer capabilities for matching information returns to tax returns, IRS also has opportunities to improve the computerized processing of information returns and its overall computer productivity. During 1979 an IRS team made a comprehensive study of the information returns program and recommended a streamlined system design for processing the returns. The study group reported that file size and processing time could be reduced by about one-half

throughout the information returns processing system. Also, we found that better matching between job requirements and computer resources could substantially improve computer productivity at the National Computer Center. We believe a concerted effort is needed now to redesign the information returns processing system and improve computer productivity, and also to prevent roll-over of old, inefficient procedures to the new computer equipment IRS is planning to acquire. IRS has agreed to or is currently taking action on all of our recommendations. If you have no objections, Mr. Chairman, we would like to make this report part of the record.

Our June 1979 report, "IRS Can Better Plan For and Control Its ADP Resources" (GGD-79-48), also addressed some of these problems and made recommendations for improving the organization of IRS' data processing staff to deal with these kinds of problems. IRS also accepted those recommendations.

Inattention to the computerized operations can be costly and wasteful. For example, because of weak controls over changes made to computer programs in the 1977 matching program, the computer made a mistake in calculating the dollar tolerance used to decide whether underreporter cases should be established. At least 1 million cases

were incorrectly dropped. The error was caught and corrected during the 1978 match, but that caused IRS to get 0.9 million more cases than it was budgeted to work. As a result of not working these 1.9 million cases, IRS will probably lose well over \$100 million in tax revenue.

Returns for liquidating distributions (Form 1099L) currently do not separately identify non-taxable distributions of capital or short-term taxable gains and losses. Because of the difficulty in matching the composite amount against tax returns, IRS has not used the 1099Ls it receives. However, IRS plans to try matching them beginning with tax year 1980.

In conducting the 1976 match, IRS did not pick up pension income correctly from the 1040 tax returns. Neither we nor IRS know how many incorrect cases this error produced nationally, but our work at one IRS service center indicates the number of such cases may have been quite high. Of that center's 347,000 cases, at least 75,000 or about 21 percent were dropped because of problems with pension data. The pension problem was corrected for the tax year 1977 match.

You also asked, Mr. Chairman, whether GAO has reached any conclusions on whether IRS should have some type of budgetary independence as an aid in achieving a full 100 percent document matching program. We have not. Our initial reaction is that there are several things which could be done to increase the scope and effectiveness of the document matching program which do not require such independence. These changes are not dramatic, but they would require a lot of management attention and commitment. For example, the use of optical character recognition equipment for transcribing paper documents and a vigorous magnetic media promotion program would go a long way toward solving the problem of getting more documents matched at less cost. A vigorous penalty assessment program on payers who do not submit documents properly, and a program to get Federal agencies to submit all of them would also help. Tight internal control over computer programs which select underreporter cases should also help generate better cases. Notwithstanding the improvements which could result from these actions, additional funds would still be necessary to achieve a 100 percent matching goal. For Fiscal Years 1979 through 1981, IRS has not sought funding to achieve a complete match.

We have summarized, in Attachment IV, the budget history for document matching in fiscal years 1979 to 1981 and compared it with enforcement programs and other IRS programs. For fiscal year 1979, IRS requested resources to provide for a 50 percent paper match. Treasury agreed, but OMB rejected the request. IRS and Treasury appealed this decision to the President, but OMB's decision was upheld. For fiscal 1980, IRS requested only enough resources to maintain a 15 percent paper match level. Treasury eliminated 173 staff years or \$4 million which it believed was unnecessary to maintain this level. This decision was accepted by OMB. For fiscal year 1981, IRS requested resources for a 25 percent paper match. Treasury and OMB upheld IRS' request. Although IRS has not requested funds for a significant expansion of the paper matching program, funds requested and provided for document matching have increased at a greater rate than for other IRS programs.

In Attachment V, we show the effect of various levels of paper processing. At the current 25 percent paper level, IRS will be able to match 76 percent of all information documents received at a cost of \$85 million. This will yield \$483 million or \$5.70 for each dollar spent. At the 100 percent level, \$125 million would be required which would return \$590 million to

the Treasury for a yield of \$4.70 for each dollar spent. There is no doubt that IRS could do more if it was provided additional funds. But, funding alone is not the solution. The opportunities for improvements in its operations discussed above deserve early attention by IRS.

The Congress can also help by acting to establish withholding on interest, dividends, and independent contractors; and to increase the penalties for failure to file information returns.

Mr. Chairman, we would be pleased to respond to any questions.

TYPES OF INFORMATION RETURNS
RECEIVED, PROCESSED, AND MATCHED
FOR TAX YEAR 1978

<u>Type of Information Return</u>	<u>Number Received</u>	<u>Number Processed</u>	<u>Number Matched</u>
	-----number in thousands-----		
Returns Filed With SSA:			
Individual wages, pensions, and annuities (W-2, W-2P)	182,600	159,102	
Returns Filed With IRS:			
Gambling winnings (W-2G)	379	359	
Interest (1099, 1087 INT)	229,008	184,538	
Dividends (1099, 1087 DIV)	72,347	58,689	
Miscellaneous business payments (1099, 1087 MISC)	16,382	4,231	
Medical insurance payments (1099, 1087 MED)	4,418	3,002	
Original issue discounts (1099, 1087 OID)	1,536	958	
Non-employee compensation (1099 NEC)	-0-	-0-	
Fishing boat crew compensation (1099F)	57	9	
Distributions from cooperatives (1099 PATR)	2,886	987	(note a)
Profit sharing and retirement plans (1099R)	2,656	903	
Bearer certificates of deposit (1099 BCD)	-0-	-0-	
Unemployment compensation (1099 UC)	-0-	-0-	
Liquidation distributions (1099L)	426	-0-	
Individual retirement accounts (5489)	-0-	-0-	
Distribution of small businesses, partnerships, and fiduciaries (K-1)	9,800	2,263	
Foreign income	626	281	
Agricultural subsidies	1,537	1,404	
Subtotal	<u>342,058</u>	<u>257,624</u>	
Total	<u>524,658</u>	<u>416,726</u>	<u>397,000</u>

a/ Breakout by type of information return is not available.

INFORMATION RETURNS
RECEIVED AND PROCESSED
TAX YEARS 1974 TO 1978

	<u>Tax Year</u> <u>1974</u>		<u>Tax Year</u> <u>1975</u>		<u>Tax Year</u> <u>1976</u>		<u>Tax Year</u> <u>1977</u>		<u>Tax Year</u> <u>1978</u>	
	<u>Number</u>	<u>% of number received</u>	<u>Number</u>	<u>% of number received</u>	<u>Number</u>	<u>% of number received</u>	<u>Number</u>	<u>% of number received</u>	<u>Number</u>	<u>% of number received</u>

----- (numbers in millions) -----

Received:

On magnetic media	186	41%	217	46%	248	52%	276	55%	444/a	86%
On paper	265	59%	255	54%	233	48%	228	45%	73	14%
Total	451	100%	472	100%	481	100%	504	100%	517	100%

Processed to NCC:

From magnetic media	163	88%	188	87%	207	83%	232	84%	401/a	90%
From paper	17	6%	36	14%	36	15%	39	17%	16	22%
Total	180	40%	224	47%	243	50%	271	54%	417	81%

Matched	158	35%	201	42%	228	47%	253	50%	397	77%
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----- (dollars in millions) -----

Revenue	\$ 98	\$275	
Less refunds	26	94	(Reliable estimates not available from IRS)
Net Yield	\$ 72	\$181	
Program Cost	\$ 27.1	\$ 37.4	
Net Yield to Cost Ratio	\$2.7 to 1	\$4.8 to 1	

a/ Includes 182.6 million wage documents received by Social Security under the Combined Annual Wage Reporting Program (123.3 million on paper).

YIELD OF IRS COMPLIANCE PROGRAMS
FISCAL YEAR 1979

<u>Program</u>	<u>Dollar Yield</u> <u>(Millions)</u>	<u>Yield Per</u> <u>Dollar of Cost</u>
Document matching	\$362 ¹	\$3.9
Examination of returns	4673 ¹	4.0
Collection programs		
Delinquent accounts	4900	23.0
Taxpayer delinquency investigations	1400 ¹	14.9
Returns compliance program	21 ¹	3.7
Criminal investigations		
Special enforcement	*	*
General enforcement	*	*
Math errors and unallowable items	549 ¹	*

* Cost or yield information is not available

1/ Dollars assessed less refunds, if any.
Dollars collected are not available for
all programs.

HISTORY OF BUDGET REQUESTS, FISCAL YEARS 1979 THROUGH 1981
(DOLLARS IN MILLIONS)

ATTACHMENT IV

	<u>Initial Request</u>	<u>Percent of Reduction</u>	<u>Treasury Allowance</u>	<u>Percent of Reduction</u>	<u>OMB Allowance</u>	<u>Percent of Reduction</u>	<u>Appropriation</u>	<u>Difference from Original Request</u>	<u>Percent of Reduction</u>
1979:									
Document Matching ¹	\$ 65	-	\$ 65	21.5	\$ 51	-	\$ 51	\$-14	21.5
Enforcement Expenses ²	1344		1320		1194		1191	-153	11
Other Programs	<u>1112</u>		<u>1007</u>		<u>962</u>		<u>954</u>	<u>-158</u>	14
Total ³	<u>2456</u>		<u>2327</u>		<u>2156</u>		<u>2145</u>	<u>-311</u>	13
1980:									
Document Matching ¹	57	7.0	53	-	53	-	53	4	7.0
Enforcement Expenses ²	1400		1286		1203		1271	-129	9.2
Other Programs	<u>1182</u>		<u>1047</u>		<u>980</u>		<u>1020</u>	<u>-162</u>	13.7
Total ³	<u>2581</u>		<u>2333</u>		<u>2182</u>		<u>2291</u>	<u>-290</u>	11.2
1981:									
Document Matching ¹	85	-	85	-	85	-			
Enforcement Expenses ²	1354		1338		1323				
Other Programs	<u>1140</u>		<u>1026</u>		<u>1036</u>				
Total ³	<u>2495</u>		<u>2364</u>		<u>2359</u>				

1/ Document matching is a multifunctional program. Its budget is included in the two categories below.

2/ Examination, appeals, tax fraud and collection programs.

3/ Totals may not add due to rounding.

ATTACHMENT IV

BENEFIT/COST ANALYSIS OF EXPANDING
THE MATCHING PROGRAM FOR TAX YEAR 1980^{a/}

	Current Request To Congress <u>25% Paper</u>	<u>33-1/3% Paper</u>	<u>75% Paper</u>	<u>100% Paper</u> ^{b/}
Number of returns to be matched (millions)	433	452	500	530
Percentage of returns to be matched	76%	79%	88%	93%
Net yield (millions)	\$483	\$515	\$565	\$590
Program cost (millions)	\$85	\$102	\$118	\$125
Yield to cost ratio	\$5.70 to 1	\$5.00 to 1	\$4.80 to 1	\$4.70 to 1

a/ These estimates were prepared by IRS in September 1979 for the fiscal year 1981 budget presentation. We did not evaluate the assumptions or data underlying these estimates.

b/ The program costs and benefits at this level reflect transcription of all paper information returns, but not all would be matched to tax returns. The information returns not matched would include returns for amounts below a tolerance level and returns with invalid or missing TINs which could not be corrected.

ATTACHMENT V