

**The Internal Revenue Service Should Evaluate
the Feasibility of Using Available Documents
to Verify Information Reported on Business
Tax Returns**

September 2002

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 18, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Final Audit Report - The Internal Revenue Service Should
Evaluate the Feasibility of Using Available Documents to Verify
Information Reported on Business Tax Returns
(Audit # 200230001)

This report presents the results of our review of the Internal Revenue Service's (IRS) use of information documents for business taxpayers.¹ The overall objective of this review was to evaluate the extent to which the IRS used available financial data on information documents to verify what taxpayers reported on their business tax returns.

Banks and other financial institutions file information documents with the IRS that contain information required to be reported on both business and individual tax returns. The IRS routinely uses information documents, such as Wage and Tax Statements (Forms W-2), it receives for individual taxpayers to verify what the taxpayers reported on their U.S. Individual Income Tax Returns (Forms 1040).

In summary, we found that the IRS does not routinely use the information documents it receives for businesses and, except for some limited uses, has not evaluated the different types of information documents to determine if they can be used to verify information reported on business tax returns. For Tax Year 2000, the IRS received over 100 million of these information documents for businesses, including those reporting income from interest, dividends, rents, and royalties. Although the total dollar value of the 100 million information returns is not known, IRS records show that it received

¹ For the purposes of this report the term "business" will be used to describe any taxpayer who has an Employer Identification Number (EIN). An EIN is a unique nine-digit number used to identify a taxpayer's business account. In reality, however, these could be entities other than businesses, such as a government agency.

approximately 2.7 million information documents reporting income or other financial information totaling \$380 billion² for businesses that filed a U.S. Corporation Income Tax Return (Form 1120).

Information returns are used by tax practitioners and others to complete tax returns and could potentially be used by the IRS to verify them. However, the IRS currently performs limited matching on business tax returns. Included in the matching program are sole-proprietors who file a Form 1040 with a Profit or Loss From Business (Schedule C) using an Employer Identification Number. The IRS is beginning to match the information taxpayers have provided on Partner's Share of Income, Credits, Deductions, etc. (Forms K-1) to their Forms 1040.

IRS management has cited several reasons why information return documents cannot be matched to business tax returns. However, we found that the IRS and General Accounting Office (GAO) provided solutions to these same barriers in a 1991 GAO report titled, *Benefits of a Corporate Document Matching Program Exceed the Costs* (Reference Number GAO/GGD-91-118, dated September 1991).

The IRS may potentially have the documents to identify many business taxpayers who are not compliant with the tax code, including those who do not report the proper income and deductions, as well as those who have not filed. The Small Business/Self-Employed (SB/SE) Division has acknowledged significant tax compliance problems with its taxpayer group. Information documents could be used to help address these problems.

We recommended that the Director, Compliance, SB/SE Division, evaluate all types of information documents the IRS receives for businesses to determine if they can be used to increase business tax compliance. Also, based on the evaluation of information documents, the IRS should consider the feasibility of legislative changes to require that additional information returns be issued for corporations, where applicable, so that the IRS has more complete information on businesses.

Management's response was due on September 16, 2002. As of September 17, 2002, management had not responded to the draft report.

Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs) at (202) 622-3837.

² These information returns generally include ones that reported proceeds from stocks, profit on bonds, and cancellation of debt.

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The Internal Revenue Service Should Evaluate the Feasibility of Using Available Documents to Verify Information Reported on Business Tax Returns

Background

Banks and other financial institutions file information documents with the Internal Revenue Service (IRS) that contain information required to be reported on business and individual tax returns. The IRS routinely matches information documents, such as Wage and Tax Statements (Forms W-2), it receives for individual taxpayers to verify what the taxpayers reported on their U.S. Individual Income Tax Returns (Forms 1040).

During Calendar Year 2001, the IRS' matching programs were the subject of Congressional hearings. The Congress was concerned that publicity surrounding the IRS' drop in examination rates was sending individual taxpayers the message that cheating on their tax returns was easy and that getting caught was unlikely.

What became clear in those hearings is that wage earners that receive Forms W-2 from their employers and file Forms 1040 have their wages verified. In addition, wage earners that have only wage and interest income and take the standard deduction have their entire return checked for accuracy. The purpose of the hearings was to remind taxpayers that if they file an inaccurate return they have a good chance of being caught.

The hearings also raised concerns about what is not being verified and how that might cause the public to perceive the tax system as unfair. In his Congressional testimony on May 8, 2001 before the Joint Committee on Taxation, the IRS Commissioner indicated that the IRS must use different compliance measures to ensure different taxpayers are paying their fair share of taxes. He also indicated that it is easier to verify the tax returns of individual wage earners than it is to verify the returns of businesses.

In a previous Treasury Inspector General for Tax Administration (TIGTA) review,¹ we reported that the IRS' Automated Underreporter Program (AUR) does little, if any,

¹ *Management Advisory Report: Comparing the Internal Revenue Service's Verification of Income for Wage Earners and Business Taxpayers* (Reference Number 2001-30-166, dated September 2001).

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business matching. IRS officials described the AUR as an individual taxpayer program.

We conducted this audit in the IRS National Headquarters and the Brookhaven IRS Campus from January to April 2002. The audit involved the Small Business/Self-Employed (SB/SE) Division's Compliance function. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Internal Revenue Service Makes Little Use of Available Documents to Verify Business Income

The IRS has not recently evaluated the different types of information documents it receives for businesses to determine if they can be used to verify information reported on business tax returns.² Forms 1099, for example, are used to report several different types of income such as interest, dividends, rents, and royalties.

The IRS received over 100 million such information documents for businesses for Tax Year (TY) 2000. Although the total dollar value of the 100 million information returns is not known, IRS records show that it received approximately 2.7 million information documents reporting income or other financial information totaling \$380 billion³ for businesses that filed a U.S. Corporation Income Tax Return (Form 1120).

² A GAO report titled, *Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs* (Reference Number GAO/GGD-91-118, dated September 1991), recommended that the IRS pursue the use of Business Master File Information Documents. SB/SE Division management informed us that the IRS' Examination Division (under the pre-2000 IRS organizational structure) developed a test of their use of the data called the Business Information Database (BID). The Examination Division tested the feasibility of using business information documents to identify and build cases on business non-filers and identify gross underreporters of business income. The BID project has been discontinued and SB/SE Division management stated that another system is being developed for non-filers.

³ These information returns generally include ones that reported proceeds from stocks, profit on bonds, and cancellation of debt.

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The IRS' Tax Compliance Activity Report, dated April 2002, makes clear that those who comply with the tax law should have confidence that other taxpayers are also complying. In addition, the report states that there should be fair application of the tax law.

The IRS concentrates income and deduction matching programs on individual taxpayers and sole-proprietors

The IRS is using Forms W-2 to verify that individual taxpayers report all of their wages on Forms 1040. In addition, the IRS uses other information documents it receives to verify individual taxpayers' Forms 1040 that include, but are not limited to, their interest income, dividend income, and mortgage interest paid.

This year the IRS is beginning to match taxpayers' Partner's Share of Income, Credits, Deductions, etc. (Schedule K-1) to their Forms 1040. Information on the Schedule K-1 is required to be reported on the partners' individual tax returns. The IRS will be verifying that the amounts on the Schedules K-1 are properly reported on the Forms 1040.

We have reported on the initial stage of the Schedules K-1 matching in a separate report. In that audit, we found that some direct matching from the partnerships' Schedules K-1 to the partners' Forms 1040 has been difficult.⁴

The IRS matching programs also include sole-proprietors who filed Forms 1040 with a Profit or Loss From Business (Schedule C) using an Employer Identification Number (EIN).⁵ Since the individual taxpayer has an EIN for the business, the information documents associated with that EIN are matched to the individual's Form 1040 and attached

⁴ *The Internal Revenue Service Successfully Processed Schedules K-1 for Its Matching Program, However, Tax Form Changes Would Reduce Unnecessary Notices to Taxpayers* (Reference Number 2002-30-141, dated July 2002).

⁵ For the purposes of this report the term "business" will be used to describe any taxpayer who has an EIN. An EIN is a unique nine-digit number used to identify a taxpayer's business account. In reality, however, these could be entities other than businesses, such as a government agency.

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schedules. However, in TY 2000 the IRS estimates that only 2.4 million of the 19.9 million Schedules C filed contained an EIN.

Beyond focusing on individuals, the Combined Annual Wage Reporting (CAWR) Program uses Forms W-2 to verify the wages on an Employer's Quarterly Federal Tax Return (Form 941). The program is designed to assist the Social Security Administration (SSA) in assuring that all workers get credit for the social security tax they pay.

The CAWR Program works cases where the wages on the Forms W-2 are less than those on the Forms 941. In those instances, the SSA is concerned that not all workers are getting credit for their social security tax contributions.

Finally, the IRS performs matching on the Employer's Annual Federal Unemployment (FUTA) Tax Returns.

Information returns the IRS matching programs could potentially use to verify business tax returns

The IRS receives over 30 different types of information documents. In the SB/SE Division document titled "Strategy and Program Plans" dated July 24, 2000, the IRS acknowledged that it had not taken advantage of information documents as a compliance tool for business taxpayers.

The following table lists some of the different business information documents issued to significant numbers of businesses that potentially could be used by IRS compliance programs.

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<i>Information Return Document</i>	<i>Number IRS Received for Businesses</i>	<i>What Is Reported on the Form</i>	<i>Legally Required to Be Issued to Corporations?</i>
Form 1099-A, B, C, OID	34,724,953	Acquisition or abandonment of secured property, stock, debt cancellation, and profit on bonds	Yes
Currency Transaction Report	11,792,909	Currency transactions over \$10,000	Yes
Form 1099-Misc, Int	44,936,766	Miscellaneous income	Sometimes

Source: TIGTA analysis of information documents issued to businesses in TY 2000.

Barriers and possible solutions to implementation of a business information document matching program

SB/SE Division Compliance function management cited the following reasons why, in their view, information documents cannot be used to verify business returns:

- *Calendar* year income is reported on information documents, but many businesses file *fiscal* year tax returns.
- Information documents report payments using the *cash method of accounting*, while corporations often report their income using the *accrual accounting method*.
- Current tax law does not require business income to be reported on information documents.

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These are the same reasons cited in a General Accounting Office (GAO) report titled, *Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs* (Reference Number GAO/GGD-91-118, dated September 1991). The report recommended that the IRS develop a corporate matching program. The report analyzed several issues perceived by the IRS as possible “barriers and burdens to the business community” if a corporate matching program were to be implemented.

The GAO found that effective solutions were possible for each issue, providing certain actions are taken by the IRS, the Congress, and the corporate community.

Calendar Year Reporting - In its report, the GAO quoted IRS officials as saying erroneous underreporter cases would be generated because calendar year income is reported on information documents, while many businesses file fiscal year tax returns. The IRS had two proposed solutions to reconcile fiscal year and calendar year documents. One of the proposals would require the business information documents to report income on a monthly basis. The other possible solution would require a business to attach an additional schedule to indicate how the business reconciled the information document to the tax return.

Cash vs. Accrual Accounting - To resolve this matching problem, the IRS proposed that corporations be required to use the cash basis of accounting on information documents. The GAO did not endorse this solution. Instead, it recommended the IRS perform reconciliations.

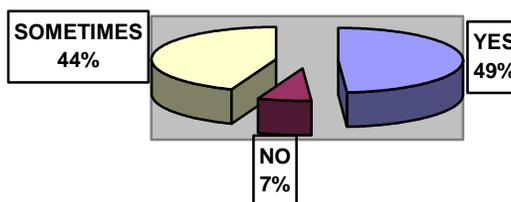
Legal Requirements for Information Returns - The Internal Revenue Code exempts financial institutions from issuing some information documents to corporations. The GAO recommended that the Congress change the information filing requirements for corporations to require more payments to corporations to be reported. While some information documents are not required, approximately 50 million (49 percent) of the information documents that the IRS received for businesses in TY 2000 had mandatory filing requirements.

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There are several types of information documents, involving about 45 million documents in TY 2000, that are required to be filed only under certain conditions. For example, Interest Income (Form 1099-Int) is generally not required to be issued to a corporation and filed with the IRS, except when there is a Real Estate Mortgage Investment Conduit for those who invest in Real Estate Mortgages. We were not able to determine how many of the 45 million were actually required to be filed. Ultimately, additional research is needed to determine whether specific information documents are required to be filed and whether they can be used in a business matching program.

The following chart illustrates that, of the over 100 million business information documents received by the IRS for TY 2000, most were required to be filed.

Are Information Returns for Businesses Legally Required to Be Filed?



Source: TIGTA analysis of information documents issued to businesses in TY 2000.

The IRS needs to evaluate business information documents to increase business tax compliance

SB/SE Division Compliance function personnel advised us that one reason for the high volume of business information documents received is that the conditions under which an information document is required to be filed are complex. It is easier for financial institutions to issue them to all businesses rather than discern which ones meet the criteria.

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Information documents are used by practitioners and others to complete tax returns and could be used by the IRS to verify them.

The SB/SE Division has acknowledged significant tax compliance problems with its taxpayer group. Information documents could be used to help address these problems.

Until the IRS began the Schedule K-1 matching process, it did not know what could be matched. Similarly, the IRS does not know which of the information documents issued by banks and others can be used to verify business tax returns.

Congressional action requiring financial institutions to more fully report corporate interest and dividends would enable the IRS to have a better matching program. However, the IRS should not wait for Congressional action. The IRS needs to review the information documents it already receives to determine how they can be used to verify business tax returns.

The IRS' new structure focusing on taxpayer groups would allow the SB/SE Division to develop specialized knowledge of business information documents. The Division then can use this knowledge to make the most use of business information documents in improving tax compliance.

Recommendations

The Director, Compliance, SB/SE Division, should:

1. Evaluate all information documents the IRS receives for businesses to determine if they can be used to increase business tax compliance.
2. Based on the evaluation of business information documents, consider the feasibility of legislative changes to require the filing of additional information documents for corporations, where applicable.

Management's Response: Management's response was due on September 16, 2002. As of September 17, 2002, management had not responded to the draft report.

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine the extent to which the Internal Revenue Service (IRS) used available financial data on information documents to verify what taxpayers reported on their business tax returns. To accomplish our objective, we:

- I. Determined what measures the Small Business/Self-Employed (SB/SE) Division has taken to use data from information documents issued for businesses and what is planned for the future.
 - A. Interviewed National Headquarters management to determine how the Automated Underreporter Program was established. In addition, determined what the SB/SE Division is currently working on and plans to work on in the future.
 - B. Reviewed recommendations from prior reports and studies to determine if the IRS implemented or plans to implement recommended actions.
- II. Evaluated and determined the purpose(s) of the different types of information documents issued for businesses.
 - A. Determined if a legal requirement exists to file the information documents.
 - B. Determined if a monetary value could be assigned to the forms.
- III. As part of evaluating the IRS' current and future business matching programs, contacted SB/SE Division Compliance function managers to determine if there was any information document database or technology being used or developed.
 - A. Determined what technology exists.
 - B. Determined what will be implemented.
 - C. Evaluated what information documents will be used.

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Appendix II

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Appendix III

Report Distribution List

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