

GAO

United States General Accounting Office

Report to the Chairman, Subcommittee
on Commerce, Consumer, and Monetary
Affairs, Committee on Government
Operations, House of Representatives

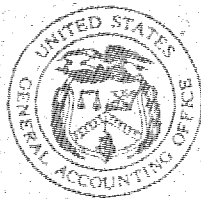
MAR 1991

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TAX ADMINISTRATION

IRS Can Improve Its Program to Find Taxpayers Who Underreport Their Income



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United States
 General Accounting Office
 Washington, D.C. 20548

General Government Division

B-242387

March 13, 1991

The Honorable Doug Barnard, Jr.
 Chairman, Subcommittee on Commerce,
 Consumer, and Monetary Affairs
 Committee on Government Operations
 House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the Internal Revenue Service's program for detecting and pursuing individuals who fail to report all of their income on required tax returns. It shows that the Service can improve this program to make sure that the nation's voluntary tax assessment system remains strong.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of issuance. We will be sending copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

Major contributors to this report are listed in appendix VI. If you have any questions, please call me on (202) 272-7904.

Sincerely yours,

Paul L. Posner

Paul L. Posner
 Associate Director
 Tax Policy and
 Administration Issues

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Executive Summary

Purpose

The Internal Revenue Service (IRS) estimates that \$48 billion in 1987 income taxes were not paid because taxpayers underreported their income. IRS primarily identifies underreporters by computer-matching income reported on information returns (e.g., Form W-2) and on the individual tax returns. For 1987, about half of the 6.2 million underreporter cases that IRS pursued were unproductive—that is, taxpayers did not owe additional taxes.

The Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, requested that GAO determine whether IRS (1) could improve computer matching to avoid millions of unproductive underreporter cases, and (2) was prematurely closing underreporter cases where taxes had not been paid on income shown on information returns. GAO also agreed to determine whether IRS was notifying the Social Security Administration (SSA) after its underreporter work found errors in wages that were previously reported to SSA.

Background

Every year, IRS receives hundreds of millions of information returns from employers and others on payments to individuals, including wages that employers report to SSA on Forms W-2. IRS computer-matches these payments to income reported on the taxpayer's return. If such income is not found, IRS opens a potential underreporter case.

IRS then determines which cases to refer to an IRS service center, on the basis of such factors as the projected taxes and costs from pursuing cases and available resources. At a service center, a tax examiner reviews the individual's tax return to determine whether (1) the income not found in the match was reported elsewhere on the tax return or (2) the information return incorrectly reported the income. If the income was correctly reported on the information return but cannot be found on the tax return, the tax examiner attempts to contact the person to find out why. The entire process takes about 3 years.

To identify ways that IRS' computer matching could be improved to reduce unproductive cases, GAO analyzed 514 randomly selected cases from 61,000 unproductive cases at Fresno Service Center for 1987—the most recent year data were available. These cases involved two types of income—wages paid to employees (45,000 cases) and payments to self-employed persons (16,000 cases). These were among the largest of over 30 types of underreporter cases and represented 27 percent of 229,000

unproductive cases closed as of January 1990 at Fresno. GAO's results have been estimated to the population of 61,000.

Results in Brief

IRS' underreporter program has been cost-effective, but it could be more so. From 1982 to 1988, the percentage of nationwide underreporter cases that were unproductive increased from 54 percent to an estimated 66 percent. Unproductive cases (1) cost IRS money that could be spent pursuing taxpayers who owe additional taxes and (2) burden honest taxpayers who must respond to IRS' inquiries.

At the Fresno Service Center, GAO found that IRS could have used more effective computer matching to avoid about 40 percent of the 61,000 unproductive 1987 wage and self-employment cases. For example, after the match for 1987, IRS made improvements to screen out unproductive cases at its 10 service centers. One improvement was to match under-reported wages to another tax return line that might also show wages. Had IRS made such changes for 1987, it could have avoided about 25 percent of the unproductive cases. GAO found further improvements that could have screened out another 15 percent of the unproductive Fresno cases.

Had IRS' and GAO's proposed improvements been in effect for 1987 and eliminated unproductive cases, Fresno could have used the resources to pursue more productive underreporter cases. As a result, Fresno could possibly have recommended up to \$19 million in additional taxes for 1987. Further reductions in unproductive cases might be identified if IRS captured specific reasons for unproductive cases on its management information system.

GAO found that taxes had generally been paid in those cases IRS closed by determining that potential underreporters had not received the income in question. Even so, IRS did not notify SSA when the underreporter work identified persons who did not receive wages that employers reported to SSA. As a result, almost half of SSA accounts that GAO reviewed continued to overstate an estimated \$44 million in wages. Unless corrected, such overstatements may result in SSA paying people more benefits than they are entitled to receive.

GAO's Analysis

Over Half of the 1987 Unproductive Cases Were Caused by Match Problems

About 32,000 (53 percent) of the 61,000 unproductive cases occurred because of three computer match problems: (1) taxpayers reported income on tax return lines not matched, (2) payers submitted duplicate or multiple information returns for the same taxpayer, and (3) the match did not count specific changes to income that amended tax returns reported. Another 2,500 unproductive cases were caused by individuals who organized their businesses as corporations or partnerships. They provided their Social Security numbers—rather than business identification numbers—to payers of income to the business. When payers used Social Security numbers to report the income, IRS' match looked for it on individual tax returns. The match identified the individuals as underreporters, even though they properly reported the income on business tax returns. (See pp. 21-27.)

After the match for 1987, IRS changed the match to avoid many problems that GAO found. If the changes had been in effect for 1987, IRS could have avoided 15,000 (25 percent) of the 61,000 unproductive cases. For example, IRS' decision to match wages to another tax return line would have eliminated a quarter of the 15,000 cases. (See p. 28.)

GAO found further improvements to the 1987 match that would have screened out almost another 9,500 (15 percent) of the unproductive cases. For example, IRS could have included even more tax return lines in the match's search for income. However, IRS officials pointed out that they would have to consider whether doing so would eliminate productive underreporter cases. For example, underreported wages might escape detection if the computer search incorrectly assumes that income reported on other lines offsets the underreported wages. IRS officials said they have procedures to minimize this problem, such as limiting the number of times that another line can be used to reduce the underreported amount. (See pp. 25, 28, and 29.)

In addition, IRS could have used SSA data to identify employers who submit duplicate Forms W-2 on wages paid to employees. As a result, IRS could avoid even more unproductive cases. IRS officials were not aware that these SSA data could be used in this fashion until April 1990. (See p. 26.)

Further, by analyzing selected cases, GAO found that taxes had been paid on most unproductive cases that IRS closed after determining that someone other than the potential underreporter received the income shown on information returns. (See pp. 27 and 28.)

IRS' management information system does not identify specific reasons for unproductive cases. It only records general results, such as "no change to original tax liability." As a result, IRS occasionally does special studies to identify ways to avoid unproductive cases. A coding system such as the one GAO used in its review could provide IRS with the specific reasons for unproductive cases. (See pp. 30-31.)

IRS Should Provide SSA With Corrected Wage Data

IRS did not notify SSA after the underreporter program found errors in wage data that employers previously reported to SSA. As a result, SSA's accounts for 7,050 of a selected 14,530 unproductive wage cases at Fresno overstated wages by an estimated \$44 million. These cases involved three reasons for unproductive wage cases where IRS' corrected data might have the most effect on SSA's accounts. (See pp. 34-36.)

Although SSA had requested a sample of the corrected wage data, IRS officials said the law regulating disclosure of taxpayer information may prohibit such sharing. GAO disagrees with this narrow interpretation and believes the data should be provided to SSA to assure that people are paid the proper amount of Social Security benefits. (See pp. 36 and 37.)

Recommendations

To avoid unproductive underreporter cases, GAO recommends that the Commissioner of Internal Revenue modify the computer match to (1) check more tax return lines for underreported income, (2) identify more duplicate information returns, and (3) count income reported on amended tax returns.

GAO also makes recommendations to the Commissioner of Internal Revenue on (1) notifying taxpayers to provide payers with business identification numbers, (2) recording specific reasons for unproductive underreporter cases, and (3) providing SSA with corrected wage data from the underreporter program.

Agency Comments

In a February 25, 1991, letter, the Commissioner of Internal Revenue generally agreed with the recommendations. He described changes that IRS had made and is making to improve the underreporter program. (See pp. 32 and 37 and app. IV.)

In a February 22, 1991, letter, the Commissioner of Social Security strongly supported the recommendation on IRS providing corrected wage data from its underreporter program to SSA. (See p. 37 and app. V.)

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Abbreviations

CAWR	Combined Annual Wage Reporting
EIN	Employer Identification Number
IRS	Internal Revenue Service
NEC	Nonemployee Compensation
SSA	Social Security Administration
SSN	Social Security Number

Introduction

Our tax system relies on taxpayers to voluntarily assess their tax liability, file returns, and pay taxes on time. Without voluntary compliance, the Internal Revenue Service (IRS) cannot administer the nation's tax laws. People who do not voluntarily report all income on their tax returns (i.e., underreporters) diminish the public's respect for and jeopardize our tax system. Moreover, not reporting all income is unfair to honest taxpayers who must then bear a larger share of the tax burden. IRS estimated that \$48 billion in federal income taxes were not paid in 1987 because people did not report all their income when filing required income tax returns.

The IRS Underreporter Program

IRS' National Examination Division has principal responsibility for overseeing policies and procedures on checking whether people report all taxable income. If an IRS examiner, normally at an IRS service center, determines that a taxpayer underreported such income, IRS will assess any additional taxes owed. However, if IRS finds that the taxpayer did not underreport, it closes that case without recommending additional tax assessments, which makes the case unproductive.

IRS' Underreporter Program detects potential underreporters when the income shown on information returns (e.g., Form 1099 or Form W-2) cannot be found on the individual's tax return.¹ IRS does this through a computer match. When the match shows a tax return that does not report all income shown on information returns, IRS creates a potential underreporter case.

Information returns are submitted by employers, corporations, banks, and other payers. In 1989, IRS received almost 1 billion information returns on various payments, such as wages, interest, and dividends. For example, businesses are required to report annual payments of \$600 or more to self-employed persons (i.e., independent contractors) or partnerships for services performed. These payments—referred to as non-employee compensation (NEC)—are reported to IRS on Form 1099-MISC (Statement for Recipients of Miscellaneous Income).

For tax year 1987, IRS' match identified about 17.9 million potential underreporters. IRS did not pursue about 11.7 million of these individuals for various reasons, such as the small amounts of potentially unreported income compared to the costs of pursuing the case with the staff available. IRS sent the remaining 6.2 million cases to tax examiners at

¹ Appendix I lists types of information returns submitted to IRS and the SSA.

service centers. For tax year 1988, IRS expects to send over 9 million underreporter cases to service centers.

IRS Process for Investigating Potential Underreporter Cases

The underreporter program takes about 3 years to complete from the time tax returns were to have been filed. For example, tax year 1987 returns were due by April 1988, unless extensions were approved, and IRS completed all underreporter phases by December 1990.

During 1988, IRS entered 1987 tax returns and information returns into its Individual Master File and Information Returns Master File, respectively. During early 1989, IRS computer-matched the information returns and tax returns to identify potential underreporter cases for over 30 types of income. For example, if the match showed that the taxpayer reported \$30,000 in wages and Forms W-2 showed \$40,000 in total wages for a person with the same name and Social Security number (SSN), IRS created a potential underreporter case.

IRS has various checks to avoid unproductive cases. For example, IRS programs its computer to match wages shown on Forms W-2 to certain lines on the tax return—other than the wage line—where taxpayers may have erroneously reported the wages. Also, to find errors by employers and other payers, the computer checks the validity of the data on the information returns. For example, the computer checks whether the taxpayer's name and SSN match on the information return and tax return. IRS officials said the matching process for identifying potential underreporters is exactly the same nationwide because it is done centrally at IRS' Martinsburg Computing Center.

After the match for tax year 1987 identified potential underreporters, IRS sent cases that involved enough underreported income to merit review to service centers. There, tax examiners attempted to resolve the cases in two stages. In the first, they manually reviewed the tax return and related information returns. In the review, they determined whether the information return income that the computer match did not find on the tax return was reported on unmatched tax return lines. The case was unproductive when the examiner closed it without recommending additional tax assessments. For tax year 1987 returns, manual reviews were done in the last half of 1989 and the first half of 1990.

Cases still unresolved moved into the second stage, where IRS tax examiners sent letters to taxpayers to ask why the income was not found on the tax return. If a reasonable explanation was provided, such as the

taxpayer did not receive the income, IRS closed the case, without recommending additional taxes. Some taxpayers agreed that they underreported the income and paid the additional taxes, plus interest and penalties. Other taxpayers contacted did not provide reasonable explanations and IRS assessed them the additional taxes, penalties, and interest.

A Also Needs Accurate Information Wages Paid

Federal law requires employers to send information returns for wages (Form W-2) to SSA, which records the data to establish a person's annual earnings. Receiving accurate wage data is critical to this effort. SSA uses the data on earnings to establish a person's entitlement to Social Security benefits and the amount of benefits. A person must meet minimum length of time and earning requirements to qualify. If qualified, a person receives benefits based on their average lifetime earnings.

To improve the data's accuracy, SSA has controls when processing the data to identify certain employer reporting errors. For example, SSA can detect when the same employer files two or more identical wage reports for the same person for the same tax year.

After processing, SSA provides the data to IRS for use in its tax compliance programs. Under an interagency agreement, SSA provides IRS with computer tapes of the wage data. This agreement focuses on IRS' and SSA's joint responsibilities in the Combined Annual Wage Reporting (CAWR) program.² Further, the agreement states that IRS will share with SSA pertinent results from its taxpayer examinations and other investigations, such as those in the underreporter program.

Objectives, Scope, and Methodology

At the request of the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, we reviewed IRS' underreporter program to determine whether

- more effective computer matching could reduce the millions of underreporter cases that now require labor-intensive manual review by service center staff only to find that no underreporting existed, and
- IRS was closing underreporter cases where taxes had not been paid on income shown on information returns.

²CAWR attempts to reconcile any differences in the annual amount of wages, among other items, reported by employers to IRS on employment tax forms (e.g., Form 941) and to SSA on W-2 forms.

During our initial work, we found that IRS was not notifying SSA of errors in wage data found during its underreporter work. As a result, we agreed with the Chairman to also see whether IRS' corrected wage data, if shared, could help SSA to improve the accuracy of the earnings shown in its Social Security accounts.

To provide historical perspective on results of the underreporter program, we collected and analyzed IRS' national statistics for several years. We determined the types of income being reviewed in the program for 1987, amounts of revenue expected from it, and trends in unproductive cases. We did not verify IRS' data. These matters are discussed in chapter 2 of this report.

To determine how computer matching could be improved to reduce unproductive cases, we analyzed 514 unproductive wage and NEC underreporter cases for 1987 that the Fresno Service Center had closed as of January 1990. (Tax year 1987 was the most recent year being reviewed by IRS.) We randomly selected these cases from an estimated universe of 61,168 unproductive wage and NEC cases.³ Of the 514 cases, we randomly selected 309 of the estimated 45,038 cases involving wages and 205 of the 16,130 cases involving NEC payments. Our analysis focused on the specific reasons why IRS determined that these 514 potential underreporters did not owe additional taxes. We also analyzed IRS' recent management studies to determine whether they identified causes and possible solutions for unproductive cases.

We chose our sample from these 2 types of income because they were among the largest of the 30 types of underreporter cases at the Fresno Service Center. In total, they represented 27 percent of all unproductive cases at Fresno, which had closed about 229,000 unproductive underreporter cases for 1987 as of January 1990. We focused our work on the underreporter process at the Fresno Service Center because IRS officials said this process is similar across all 10 service centers and because of our staff's availability. Appendix II describes our sampling methodology.

To determine whether IRS was closing underreporter cases where taxes had not been paid on the income shown on information returns, we analyzed whether taxes were paid in 43 of the 309 wage cases from our

³The original sample was 593 from a universe of 71,709 wage and NEC cases closed as unproductive. However, IRS data for 79 cases were not available for our review or were incomplete (see app. II). Therefore, we eliminated these cases from our sample and adjusted the universe to 61,168 cases.

Fresno sample. These 43 cases involved those where IRS determined that the potential underreporter did not receive the disputed wages.

In determining whether IRS' underreporter data could be used by SSA to assure that its Social Security accounts were correct, we selectively reviewed 113 of the 309 wage cases where IRS' underreporter work showed that employers had provided SSA with incorrect wage data. We reviewed the amount of wages shown in SSA's accounts for the 113 cases. Appendix II has details on how we selected and analyzed the 113 cases.

We discussed the underreporter program procedures and policies with IRS officials at the National Office and the Fresno Service Center. We also visited SSA Headquarters in Baltimore, Maryland, to discuss how SSA uses wage data in Social Security programs.

We did our field work from April 1990 through October 1990 in accordance with generally accepted government auditing standards.

IRS' Information Returns Program: An Important Tool for Assuring Voluntary Compliance With Tax Laws

Since fiscal year 1977, the number of information returns received and processed for computer matching has increased from 250 million to 1 billion in 1989.¹ However, the percentage of underreporter cases that were unproductive has increased from 54 percent in tax year 1982 to an estimated 66 percent in 1988. Since the cases require manual review by service center staff, the increase in unproductive cases means IRS spends a greater portion of its resources pursuing taxpayers who do not owe additional taxes.

Despite the increase in unproductive cases, the underreporter program remains a cost-effective method for detecting unreported income. In fiscal year 1989, the program recommended additional tax assessments of \$1.9 billion at an estimated cost of \$94 million.

If the number of unproductive cases were reduced, IRS could (1) use its staff on cases that are more likely to generate additional tax revenues and (2) reduce the burden on taxpayers who must respond to IRS' inquiry about the apparent underreporting. Two large categories of underreporter cases where reductions are possible involve wages and NEC payments to self-employed persons, as discussed in chapter 3.

Information Returns Received and Processed Have Increased Significantly Since 1977

The number of information returns sent to IRS and processed (i.e., information correctly entered into the computer) for use in the underreporter program has increased significantly since 1977. (See table 2.1.) Over time, IRS has improved methods for receiving and processing information returns, such as magnetic media reporting.

¹Data in this chapter come from IRS. We have not verified or evaluated the data or IRS' methodology for estimating them.

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Compliance With Tax Laws

Table 2.1: Number of Information Returns Received and Processed in Selected Fiscal Years, 1977-1989

Numbers in millions			
Fiscal year	Number of information returns		Percentage processed
	Received	Processed	
1977	481	243	50%
1981	568	525	92
1983	614	568	93
1985	832	801	96
1987	949	920	97
1989	989	977	99

Source: IRS.

Since 1977, the number of notices (called CP-2000) that IRS sends to taxpayers when the income on an information return cannot be found on a tax return has varied. (See table 2.2.)

Table 2.2: Number of Underreporter Notices in Selected Fiscal Years, 1977-1989

Numbers in millions	
Fiscal year	Number of notices
1977	0.42
1981	2.38
1983	2.84
1985	4.10
1987	2.24
1989	3.65

Source: IRS.

Underreporter Program Is a Cost-Effective Method of Detecting Underreported Income

IRS' underreporter program has been cost-effective. IRS' data for fiscal years 1984 to 1989 show that the program has regularly generated from \$12 to \$21 in additional recommended taxes for every \$1 spent. (See table 2.3.) For 1989, IRS estimated that about 3,100 staff-years will be used for the program at a cost of about \$94 million. For this investment, IRS projected additional recommended tax assessments of about \$1.9 billion.

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Table 2.3: Underreporter Program
Recommended Assessments and Costs,
Fiscal Years 1984-1989

Dollars in millions			
Fiscal years	Recommended assessments	Costs	Ratio
1984	\$1,186	\$62	19:1
1985	1,627	76	21:1
1986	1,808	85	21:1
1987	1,201	99	12:1
1988	1,817	98	19:1
1989	1,945	94	21:1

Source: IRS Data.

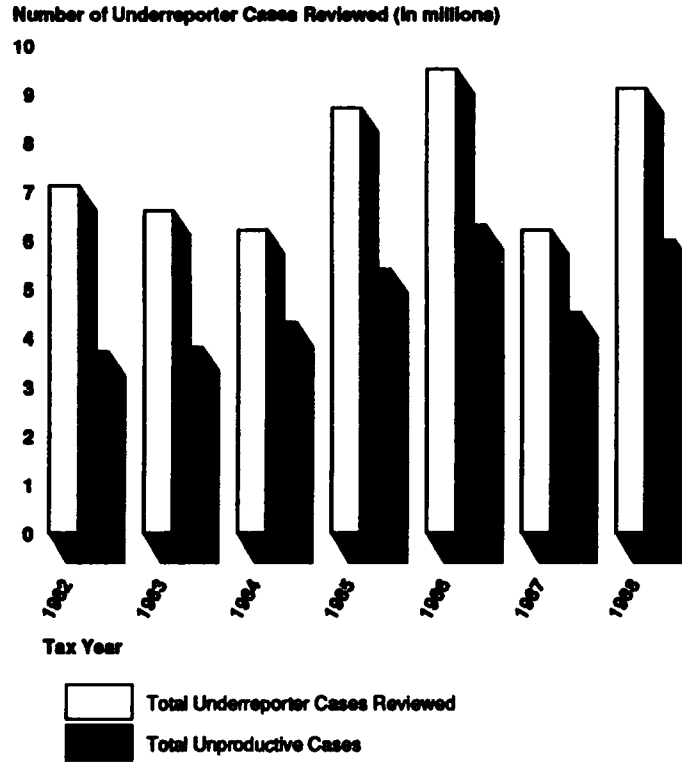
IRS Examination officials said recommended assessments dropped so much in fiscal year 1987 because IRS had largely been working tax year 1984 cases. For these cases, computer problems caused difficulties for IRS in processing the tax returns and information returns. As a result, IRS' 1984 underreporter cases generated lower recommended assessments in fiscal year 1987.

Over Half of IRS'
Underreporter Cases
Are Unproductive

Although the underreporter program is cost-effective, many unproductive cases continue to be sent to service centers for manual screening. Unproductive cases result when the computer does not detect various errors made by (1) employers or other payers in submitting information returns, and (2) taxpayers in filing tax returns, as discussed in chapter 3.

Over half of all underreporter cases for tax years 1982 to 1988 were unproductive. (See fig. 2.1.) The rate of unproductive cases has increased in recent years. IRS officials said a combination of factors—new matching requirements, fluctuating workload, and inexperienced employees—probably caused this increase.

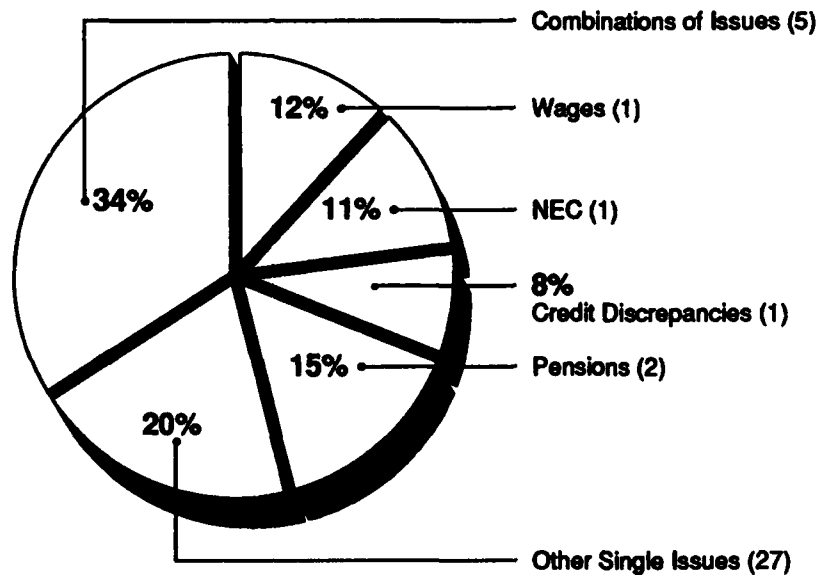
Figure 2.1: Summary of Unproductive Underreporter Cases, Tax Years 1982-1988



Note: 1987 and 1988 data are IRS estimates.
 Source: IRS data on the underreporter program.

Two of the largest categories of underreporter cases involve wages and NEC payments. Although the match includes over 30 categories, these 2 made up at least 23 percent of the 6.2 million cases reviewed nationwide for 1987. (See fig. 2.2.)

Figure 2.2: Number of Underreporter
Cases Worked by Type of Income, Tax
Year 1987



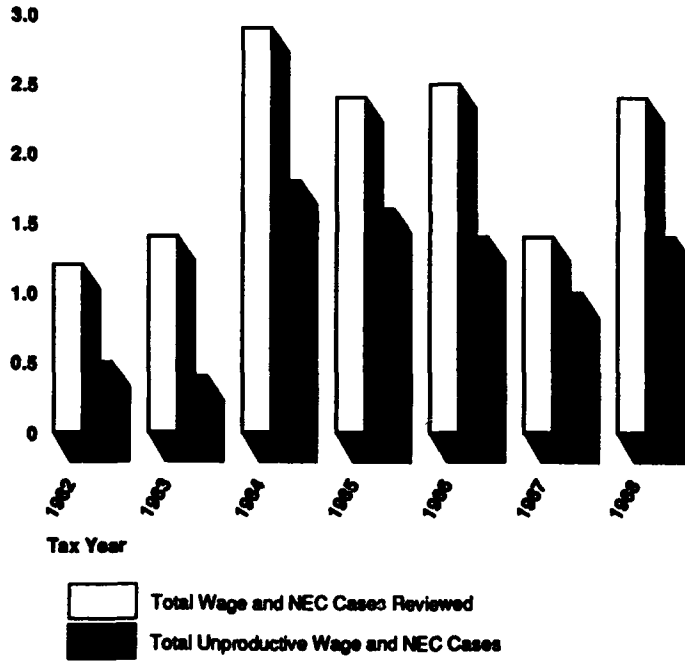
Note: Numbers in parentheses represent the number of income or expense categories in the group. Combination categories may include wages or NEC along with other income or expense categories. Source: IRS data on the underreporter program.

The national trend of unproductive wage and NEC cases has varied more than for the whole program. The trend has ranged from 29 percent for 1983 to 71 percent for 1987. (See fig. 2.3.) While IRS did not have data to explain this trend, chapter 3 examines the reasons why certain wage and NEC cases in the Fresno Service Center were unproductive for tax year 1987.

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Figure 2.3: Summary of Unproductive Wage and NEC Underreporter Cases, Tax Years 1982-1988

3.5 Number of Wage and NEC Cases Reviewed (in millions)



Note: 1987 and 1988 data are IRS estimates.

Source: IRS data on the underreporter program.

IRS Can Identify and Eliminate More Unproductive Cases Through Improved Computer Matching

About 32,000 (53 percent) of 61,000 unproductive wage and NEC underreporter cases for 1987 at the Fresno Service Center occurred because of computer matching problems. For example, the computer match did not search for income on all tax return lines where taxpayers may have reported the income shown on information returns. The other 47 percent of the cases were difficult to screen out by computer matching, which means that they required manual reviews by service center staff.

After the match for 1987, IRS recognized that improvements were needed and changed its computer matching to avoid some problems that had led to unproductive cases. For example, IRS' match now includes more lines on the tax return where taxpayers may report income. If these changes had been in effect for the 1987 match, IRS could have avoided as many as 15,000 of the unproductive cases. However, we found further improvements were possible.

Had IRS' and our proposed improvements been made before the 1987 match, Fresno Service Center would have saved money by not pursuing unproductive cases. The center could have used these savings to pursue potentially more productive underreporter cases and could possibly have recommended an additional \$18.7 million in taxes for 1987. Savings also are possible at IRS' other nine service centers, but we did not have the data to estimate them.

We also found that IRS' management information system does not show the specific reasons for unproductive cases. As a result, IRS must rely on periodic studies of a small number of closed cases to identify ways to screen out unproductive cases. IRS needs a system that shows these specific reasons so that it can evaluate possible computer match improvements without relying on special studies.

More Than Half of the 1987 Unproductive Wage and NEC Cases Were Caused by Problems With the Computer Match

We found that 32,408 (53 percent) of the 61,168 unproductive Fresno cases on potential wage and NEC underreporters for 1987 occurred because of computer match problems. Specifically, the match did not (1) search for income on tax return lines where taxpayers reported the income; (2) ignore income shown on multiple or duplicate information returns, but not earned by taxpayers; and (3) count additions to specific types of income that taxpayers reported on amended tax returns. (See table 3.1.)

The remaining 47 percent of the unproductive cases were caused by problems that were outside IRS' immediate control and that may not be

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IRS Can Identify and Eliminate More
Unproductive Cases Through Improved
Computer Matching**

easily resolved. These included cases where taxpayers mistakenly provided their SSN rather than their business tax identification number to payers of business income.

As a result, many cases may continue to require manual screening at service centers. However, with more specific information on the reasons for unproductive cases, along with notifying taxpayers of their mistakes, IRS may be able to avoid more unproductive cases in the future.

Table 3.1: Estimated Number and Percentage of Unproductive Wage and IEC Cases at Fresno for Tax Year 1987 by Reason and Type of Corrective Action

Reasons for unproductive cases	Wage cases		NEC cases	
	Number	Percent	Number	Percent
Corrective action can be taken by IRS				
Income reported on line not matched	6,946	15.4	7,616	47.2
Duplicate and multiple information returns	15,532	34.5	a	a
Amended tax returns	a	a	a	a
Subtotals	24,016	53.3	8,392	52.0
Corrective action difficult to implement^b				
Business income reported as personal income	0	0.0	2,546	15.8
Miscellaneous ^c	21,022	46.7	5,192	32.2
Subtotals	21,022	46.7	7,738	48.0
Totals	45,038	100.0	16,130	100.0

^aCases in these categories are part of the subtotals but are too few to do statistically reliable estimates.

^bThese problems would be hard for the computer match to identify.

^cIncludes other than computer matching problems, such as income reported for the wrong taxpayer and less frequent problems with computer matching, nontaxable income, income reported on two or more lines, among others.

The following sections discuss (1) reasons for some unproductive cases, (2) the extent to which it is practical for IRS to revise the match to avoid unproductive cases, and (3) whether IRS has developed or planned improvements to avoid the unproductive cases.

IRS Does Not Computer Match All Return Lines Where Income Is Reported

Each individual income tax return contains one clearly labeled line on which taxpayers are to report wages. Similarly, taxpayers are to report NEC income on a few specific lines on the return. Many of these wage and NEC lines are included in the computer match. However, we found that

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taxpayers reported wages or NEC income on lines not included in the match.

IRS instructs taxpayers to report wages on a tax return line for wages, salaries, and tips. IRS' computer program matches that line to the wages and allocated tips reported by payers on the Forms W-2.

In 15.4 percent of the wage cases (see table 3.1), taxpayers did not owe additional taxes because the wages were reported on about 20 other lines from tax returns or attached schedules that IRS did not match. We found that three of these lines accounted for almost all unproductive wage cases.¹ Two lines were on the Form 1040—"fully taxable pension" and "other income"—and the third line was the "gross receipts" line on the Schedule C.²

A 1989 IRS study on unproductive cases recommended matching wage discrepancies to these three lines.³ IRS changed its criteria for tax year 1988 to match the pension line but not the other two lines. IRS officials said these two lines were not matched because they had no evidence that the problem was large enough. Even so, they acknowledged that the costs to program and run the computer match would not be high.

Taxpayers also reported NEC income on lines not in IRS' match. IRS instructions specify that taxpayers who are self-employed should report their NEC business income either on Schedule C or Schedule F (i.e., farm income and deductions).

In 7,616 (47 percent) of the unproductive NEC cases (see table 3.1), taxpayers did not owe additional taxes because the NEC income was reported on about 20 lines not matched by IRS. Our case analysis showed that about five of these lines accounted for almost all of these 7,616 cases.⁴ These five lines included the (1) taxable pension line on Form 1040, (2) rents received line on Schedule E, (3) gross income line on

¹Cases for each of these three lines were too few to do statistically reliable estimates.

²This is attached to individual tax returns to report business receipts and deductions, usually from self-employment.

³IRP Underreporter Screenout Study, TY 1984, February, 1989.

⁴Cases for each of the five lines were too few to do statistically reliable estimates.

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Schedule F, (4) other income line on Schedule F, and (5) reimbursement for expenses line on Form 2106.⁵

IRS transcribes into its computer the first three lines described above. But IRS had not included them in the match because it was uncertain about how often taxpayers reported the NEC income on these lines. Further, the 1989 IRS study recommended matching to the reimbursement for expenses line on Form 2106. IRS has not matched to this line because of the perceived costs to transcribe data from the line.

Using IRS' data on the cost to transcribe a line from a tax return, we estimate that transcribing these lines on all Forms 2106 and Schedule Fs would cost \$65,000. Transcribing these two types of lines would allow IRS to computer match to all primary locations where taxpayers in our sample reported NEC income.

In reviewing our initial results, IRS officials pointed out that before deciding which, if any, additional lines to use in the match, IRS needs to consider whether doing so would inadvertently screen out productive underreporter cases. That is, the more lines that the computer searches for income—such as wages or NEC—the greater the likelihood that the match will screen out an actual underreporter. For example, an employee who fails to report wages may escape detection if the computer search incorrectly assumes that income reported on other lines can be used to offset the amount identified as underreported wages.

Although it did not have statistics on how often this problem occurs, IRS has ways to minimize it. For example, IRS has established priorities for offsetting underreported income to specific lines on the tax return where such income may be reported. IRS has procedures to govern which types of underreported income and lines to offset first.

**Computer Match Does Not
Detect All Duplicate or
Multiple Information
Returns**

We found that some employers and other payers erroneously issued duplicate information returns (e.g., Form W-2) for the same tax years and taxpayer. Other employers issued multiple returns to change one or more incorrect data elements on original returns.

For example, if an employer issues two W-2 forms on a taxpayer's wages, IRS has a control that eliminates one form if all data elements on

⁵Taxpayers should report rental income and deductions on Schedule E and employee reimbursements for business expenses on Form 2106.

both match exactly. However, if all elements do not match, the incomes are combined, even though only the income on one W-2 was actually earned by the taxpayer. When taxpayers report only the actual income, they will be identified as potential underreporters. These cases comprised 34.5 percent of the unproductive wage cases and a small portion of NEC unproductive cases. (See table 3.1.)⁶

To improve this control and eliminate more unproductive cases caused by duplicate W-2s, IRS is revising its computer criteria for tax year 1989. The computer will eliminate W-2 forms when another form has the same employer identification number (EIN) and taxpayer SSN, and dollar amounts for wage and withholding on each form match within 1 dollar. It will not do so when wage or withholding amounts exceed this 1-dollar criterion.

We also found that IRS had data from SSA on adjustments to wage data that could help to reduce unproductive wage cases. Since 1979, SSA has provided IRS with a weekly computer tape that shows changes to Forms W-2 previously provided by SSA to IRS. IRS uses the tape to reconcile wage and tax data that employers send to IRS and to SSA. IRS officials were not aware until April 1990 that SSA's corrected wage data on the tape also could be used to avoid unproductive cases. For example, in one 1987 case, the SSA tape showed a correction to wages of \$8,269. The original W-2 form reported \$20,780 while a corrected W-2 reported \$12,511. Using such corrections to reported wages would help IRS to avoid creating unproductive underreporter cases.

Amended Tax Returns Cause Unproductive Cases

Taxpayers can file amended tax returns to report changes such as additional income not shown on their original tax return.⁷ IRS does not transcribe changes to specific amounts of income such as wages. These specific amounts are reported in an explanatory section of the amended return rather than on a line. IRS only enters aggregated amounts that are reported on separate lines of the amended tax return. Such amounts include income (e.g., total and taxable), credits, deductions, exemptions, and the tax owed or to be refunded.

⁶NEC cases were too few to do statistically reliable estimates.

⁷Taxpayers should use a special tax form—Form 1040X—rather than the original form—Form 1040—to amend their original returns.

By not counting any additional wage or NEC income as reported on amended returns, the computer match identifies the taxpayers as potential underreporters. For example, a taxpayer files a Form 1040 in March showing \$20,000 in wages. The taxpayer files an amended return in April showing \$30,000 in total income, explaining that wages accounted for the extra \$10,000, and pays additional tax owed. However, the match still shows the taxpayer reporting \$20,000 in wages and creates an underreporter case when W-2 forms show the \$30,000 in wages.

IRS could avoid such unproductive cases if its match counted changes to specific amounts of income that taxpayers report on amended returns. To do so, IRS would have to code the type of income being changed and transcribe these specific amounts from the explanatory section of the amended return, which our sample cases showed to be possible. We do not know the costs of this action or magnitude of the problem nationwide. However, compared to the cost of using an examiner to manually screen out cases, the cost to modify the computer match to avoid these unproductive cases may be less.

Business Income Reported as Personal Income

Unproductive underreporter cases can occur when individuals who operate a business as a corporation or partnership mistakenly provide their SSNs rather than business identification number to payers of business income. The payers report the income as personal income under these SSNs while individuals report the income as a payment to the business. As a result, IRS' computer match will identify the individuals as potential underreporters, even though the income is paid to the business. Since the cause of these cases is not under IRS' direct control, these cases are difficult to eliminate.

IRS' underreporter program has controls to screen out business income, but they sometimes do not work. For example, IRS' match will not count income as personal income if the information return has words that describe the payee as a business. However, payers of business income do not always use such words on information returns. As a result, business income is counted as personal income and considered to be underreported. These cases accounted for 15.8 percent of the unproductive NEC cases.

Remedying this situation for a given year may be difficult. But IRS could avoid more of these unproductive cases in future years by notifying these taxpayers of the need for providing their business tax identification numbers to payers of business income.

Taxes Were Paid on Lost Closed Cases Where Wages Were Reported for the Wrong Individual

One of our objectives was to determine whether IRS was prematurely closing underreporter cases where taxes had not been paid on the income shown on information returns. In these cases, IRS concluded that the income did not belong to the potential underreporters. These cases accounted for about 10 percent of the unproductive wage and NEC cases we reviewed.

To report wages or NEC, employers and other payers use the name and SSN provided by those receiving the income. On occasion, SSA erroneously issues the same SSN to two individuals. In other cases, payers or taxpayers report the wrong SSN. Finally, a person may knowingly provide a payer with another's name and SSN. IRS officials said aliens not authorized to work in the United States may do this to obtain jobs. In such situations, IRS tries to determine whether income on information returns belongs to potential underreporters. IRS procedures require tax examiners to contact taxpayers and payers as part of this determination.

Of our 309 wage cases, we found 43 cases that IRS closed after concluding that potential underreporters did not receive the income reported on the Form W-2. We analyzed whether taxes were paid on such income and found that employers had withheld Social Security tax in all 43 cases and income tax in 26. We assume that the employers remitted these withholdings to IRS. For the 17 cases where income tax was not withheld, the average wage payment was low—\$3,608. In such cases, it is possible that the persons were exempt from withholding.

Although some of the people may have owed additional taxes beyond amounts withheld, the taxes owed would have been so small that it probably would not have been practical for IRS to pursue them. The average wage shown on information returns for the 43 cases was \$4,759. In addition, IRS would have had to incur costs to locate the people and determine their tax liabilities. Overall, we believe IRS acted reasonably in closing these cases.

IRS Could Have Assessed Millions of Dollars in Additional Taxes If Changes Had Been Made Sooner

IRS could have avoided many unproductive underreporter cases at Fresno for 1987 that occurred as a result of the three computer matching problems mentioned earlier. That is, the match did not account for income reported on (1) different tax return lines, (2) duplicate information returns, and (3) amended tax returns. Had IRS' and our improvements to the computer match been made before the 1987 match, up to 40 percent of the unproductive cases would never have been referred to the Fresno Service Center.

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We computed the 40-percent savings by applying IRS' and our improvements to our sample cases. We found that up to 24,500 of the 61,168 unproductive cases at Fresno for 1987 could have been avoided. IRS' changes to account for wages reported on the pension line and for duplicate W-2 forms could have avoided up to 15,000 unproductive wage cases. By also implementing our improvements, IRS could have avoided almost 9,500 unproductive wage and NEC cases. For example, IRS could have matched such underreported income to more tax return lines. Even more unproductive cases for 1987 could have been avoided if IRS had used SSA's corrected wage data to identify duplicate Forms W-2. Because we did not have enough of SSA's data, we could not estimate how many more cases could have been avoided.

Given the 40-percent reduction, we estimate that Fresno could have saved at least \$131,000 to \$338,000—depending on how many cases required contacts with taxpayers after manual screening. This only represents the manual resources that Fresno spent to resolve these unproductive cases. We developed this range by applying the average costs to pursue unproductive cases to the estimated 24,500 wage and NEC cases that could have been avoided for 1987.⁸

Fresno could possibly have recommended up to \$18.7 million in additional taxes for 1987 if it had used the savings to pursue unworked but potentially productive wage and NEC cases. This estimate comes from applying the national portion of wage and NEC cases that Fresno worked for 1987 to IRS' nationwide projections of tax revenue that could be realized from working underreporter cases. IRS uses a computer model to project these tax revenues.⁹

For example, as of July 1990, Fresno's portion of the national wage and NEC work load for 1987 was 12 percent. Also, IRS' model projected \$156 million in additional taxes for 1987 among wage and NEC cases that IRS ultimately decided not to pursue.¹⁰ By applying the 12 percent to the

⁸We used IRS data to compute average costs for (1) manual reviews and (2) taxpayer contacts. Since IRS did not have data on how many wage and NEC cases at Fresno reached each stage, we used the highest and lowest averages to estimate a range of savings.

⁹The model projects tax revenue based on past underreporter results. It uses the number of productive and unproductive cases and ratio of revenue to cost for each type of income. For 1987, IRS' most recent results came from tax year 1985 underreporter cases. We did not attempt to (1) verify the validity of the model or (2) subtract from the \$18.7 million the costs of implementing the recommended match changes we discussed earlier.

¹⁰These cases that IRS did not pursue had the lowest ratio—as low as \$9:\$1—of projected tax revenue to cost.

\$156 million projection, we computed additional revenues of \$18.7 million if Fresno had pursued these unworked but productive wage and NEC cases.¹¹

Although these estimated Fresno savings cannot be generalized to IRS' 9 other service centers, we believe similar savings may be possible because the (1) computer matching process is centralized at IRS' Martinsburg Computing Center and (2) other centers' work load is similar for unproductive cases involving wages and NEC—27 percent at Fresno versus 23 percent nationwide.

IRS Needs Better Data on Reasons for Unproductive Underreporter Cases

IRS' management information system does not specifically identify the reasons for unproductive underreporter cases. As a result, IRS must rely on periodic studies of the underreporter program to obtain this information. While these studies have led to improved computer matching, having a system that records the specific reasons would further improve the program.

IRS' management information system has codes to identify why unproductive cases were closed. However, these codes are too general to provide management with the specific reason why the taxpayer did not owe additional taxes. For example, one code indicates "discrepancy accounted for." This does not tell IRS management what caused the discrepancy or how it was resolved. Similarly, another code indicates "no change to original tax liability" without indicating why.

A detailed coding system, such as the one we developed for this review, could provide more meaningful reasons why IRS pursued taxpayers who did not owe additional taxes. We used the Internal Revenue Manual section for the underreporter program to develop a detailed coding system that allowed us to summarize

- the specific reasons for the unproductive cases,
- the various corrections made by tax examiners and whether they followed IRS procedures, and
- errors made by IRS in transcribing tax return data.

¹¹This is based on an assumption that the Fresno case work load is representative of the work load nationwide.

IRS could use this type of information to make more informed decisions about the costs and benefits of expanding the computer match to additional lines on returns, as well as to make other management improvements.

IRS plans to revise the current underreporter coding system as part of its Automated Underreporter System, which is to be implemented in late 1991. However, the development of that system is behind schedule.¹² When implemented, the system will allow tax examiners to more fully use computers to process and track cases and to enter results into IRS' computer. A more specific coding system could help capture these results.

Conclusions

IRS' computer matching process to identify underreporters can be improved to avoid pursuing potential underreporters who do not owe additional taxes. These unproductive cases cost IRS time and money that would be better spent pursuing taxpayers who do owe additional taxes.

We found that many unproductive wage and NEC cases for 1987 at Fresno could have been avoided by adjusting IRS' match process. For example, IRS' match could have included more lines on the return which taxpayers could have used to report income. IRS also could have used SSA wage adjustment data. When deciding what, if any, additional tax return lines to include in the match, IRS needs to carefully consider how to do so without inadvertently excluding productive cases. IRS may avoid more unproductive cases if it can educate persons receiving business income to provide the payer with the business's identification number rather than an SSN.

Also, IRS' management information system did not identify the specific reasons why potential underreporters did not owe additional taxes. This information would be very useful to IRS in making informed decisions on how to improve the match process.

Recommendations

To reduce the number of unproductive underreporter cases, we recommend that the *Commissioner of Internal Revenue* modify the computer match to

¹²Tax System Modernization: Management Mistakes Caused Delays in Automated Underreporter System (GAO/IMTEC-90-51, July 1990).

- search for income on as many tax return lines as possible without inadvertently screening out productive cases,
- use SSA's corrected wage data to identify when employers submit multiple information returns for the same taxpayer, and
- count changes to specific amounts of income that taxpayers report on amended tax returns.

We further recommend that the Commissioner of Internal Revenue (1) notify taxpayers who provide their SSNs to payers of business income to begin providing their business's tax identification numbers, and (2) modify the management information system for the underreporter program to provide specific reasons why cases were unproductive. This information, when available, should be used to monitor results and further improve the matching process.

Agency Comments and Our Evaluation

In a February 25, 1991, letter (see app. IV), the Commissioner of Internal Revenue generally agreed with our recommendations. He said IRS will

- match underreported wages to more lines and undertake an effort to avoid unproductive NEC cases;
- work with SSA to receive corrected wage data in a timely and specific fashion so that IRS can eliminate duplicate wage data;
- remind taxpayers to contact payers on using the correct tax identification number for corporations and partnerships; and
- improve its management information system to use more specific reason codes.

We support these actions. He also said IRS would need to weigh the costs of changing the amended tax return to capture changes to specific types of income against having tax examiners continue to manually screen the unproductive cases. Changing the amended return is one way to avoid these unproductive cases. We believe another approach IRS should consider would be to code and transcribe the specific changes to income, such as wages, that taxpayers already report on the existing amended return, as discussed on pages 26 and 27.

IRS Should Provide SSA With Corrected Wage Data From the Underreporter Program

When pursuing potential underreporter cases, IRS often finds that the wages previously reported by payers to SSA and IRS are incorrect. For example, IRS might find that the wages had not been paid to the taxpayer whose name and SSN appear on the Form W-2; rather, the wages had been paid to another person.

SSA needs this corrected wage data because, when a person retires and applies for Social Security benefits, the average lifetime wages shown in SSA's account determines the amount of monthly benefits the person will receive. When SSA mistakenly attributes wages to the wrong person, it could pay (1) some people excessive Social Security benefits and (2) other people less benefits than they are entitled to receive.

For selected unproductive wage cases at Fresno where we had IRS' corrected wage data, we estimate that about \$44 million in wages shown in SSA's accounts could have been overstated, as of June 1990.¹ These unproductive wage cases involved three types of errors that IRS' underreporter work identified and that may have the most effect on SSA's accounts. We discussed our results with SSA officials, who viewed them as potentially helpful in identifying errors.

In December 1989, SSA requested a sample of the corrected wage data from IRS' underreporter program. As of December 1990, IRS officials had not provided the data because they said the law regulating disclosure of taxpayer information may prohibit it. We disagree with this narrow interpretation of the law and believe IRS should provide the information.

SSA Has Controls to Catch Some Errors in Employers' Wage Reports

As discussed in chapter 1, federal law requires employers to send information returns for wages (Form W-2) to SSA, which uses the data to record a person's annual earnings and establish benefit amounts. SSA then provides the data to IRS for use in its tax compliance programs.

In processing wage data, SSA uses various controls for detecting when employers report wages incorrectly. For example, one control identifies when an employer mistakenly submits two or more W-2 forms for the same person, for the same tax year, and for the same dollar amount. However, if the amounts differ, the income on both will be credited to the account. If SSA discovers any errors, the incorrect wages will be deleted from the account.

¹All numbers are estimates based on the Fresno sample results unless otherwise indicated.

In addition, errors are sometimes found when persons retire, apply for Social Security benefits, and find incorrect wage amounts in their accounts. However, these errors are difficult to correct when the wages were reported to SSA years earlier, particularly if the employer is out of business. Further, if the error caused the earnings to be overstated, those applying for Social Security benefits may not disclose the error to SSA officials, since doing so could lower their benefits.

IRS' Underreporter Results Could Help SSA to Find Errors in Reported Wages

IRS' underreporter reviews and subsequent contacts with taxpayers and employers found errors in previously reported wage data. These errors occurred when employers submitted W-2 forms for a potential underreporter (1) on wages that actually belonged to another person, (2) more than once, or (3) with mathematical or other errors. These types of errors may have the most impact on whether SSA's accounts overstate wages paid to an individual.

We estimated that these three types of errors accounted for 21,652 of the 45,038 unproductive wage cases for tax year 1987 at Fresno.² We selectively reviewed 113 sampled cases having at least one of these three errors and found that in 66 of these cases, the SSA accounts had overstated the wages. Using these raw numbers, we estimated that 7,050 of 14,530 SSA accounts would have overstated about \$44 million in wages for 1987.³

We discussed these errors and our results with SSA officials. They said knowledge of such errors could help increase the accuracy of SSA accounts for wages paid to individuals. The reasons these three types of errors occurred and some case examples are discussed below.⁴

Employers Reported Wages That Belonged to Another Person

IRS' contacts with potential underreporters showed that employers in 3,424 cases had reported paying wages that did not belong to that person (i.e., wages were credited to another person's SSN).⁵ No one should receive credit from SSA for wages earned by another person.

²The 95-percent confidence interval produces a range of 19,321 to 23,983.

³The 95-percent confidence interval produces ranges of (1) 5,561 to 8,539 for the 7,050; (2) 11,993 to 17,067 for the 14,530; and (3) \$22 million to \$66 million for the \$44 million.

⁴The number of cases in our sample was too small to make statistically reliable estimates of the frequency or the overstated dollar amounts for each of the three types of errors.

⁵The 95-percent confidence interval produces a range of 2,261 to 4,587 cases.

However, we found that some of SSA's records showed the wages as being credited to the wrong person. For example, one particular taxpayer's information returns indicated earned wages of \$22,013 from 6 employers in 1987. IRS concluded that this taxpayer had not received \$6,707 of the wages. Even so, this taxpayer's Social Security account still showed \$22,013 in wages.

**Employers Submit Multiple
or Duplicate Wage
Information Returns**

Although SSA has controls for identifying when employers erroneously submit multiple or duplicate W-2 forms for the same taxpayer, they only work when the amount of wages on both forms matches exactly. By reviewing SSA accounts, we found that the controls allowed some wages that were reported more than once on W-2 forms to be credited incorrectly to SSA accounts, resulting in overstated wages.

The following example illustrates how IRS' underreporter results could help SSA to correct its records. In this case, an employer submitted two Forms W-2 for a person—one for \$8,026 and another for \$12,178. The person appeared to be an underreporter because he only reported \$12,178 on his tax return. However, IRS determined that the employer had only paid \$12,178 to the taxpayer. The other W-2 form for \$8,026 was erroneously submitted because the employer changed payroll accounting firms during the year. SSA's account for this taxpayer still showed both amounts.

**Some Employers Make
Errors on Wage
Information Returns**

Some employers make mistakes on the Forms W-2 that are sent to SSA. For example, they report the wrong amount of wages. SSA has controls to catch some mistakes, but it may not find them all before sending the wage data to IRS. As a result, IRS investigates taxpayers who do not owe any additional taxes. The mistakes also can result in overstating the taxpayers' SSA accounts, unless IRS notifies SSA of the errors detected during the underreporter program. Our analysis of SSA's accounts for cases having employer errors showed that most errors had not been corrected and the wages remained overstated.

The Law Does Not Preclude IRS From Providing SSA With Corrected Wage Data

While section 6103 of the Internal Revenue Code generally prohibits IRS disclosure of tax returns and associated information, specific exceptions to this general rule are provided. Several exceptions permit release of information to other federal agencies to assist them in administering the law.

One exception permits disclosure of return information relating to self-employment taxes, taxes withheld by employers, and Social Security taxes by the IRS to SSA for purposes of administering the Social Security Act. Additionally, a specific exception was added to the Code in 1976 when Congress authorized IRS and SSA to jointly process wage reporting forms. This exception permits disclosure of information returns that are necessary for SSA to effectively process these returns. The Social Security Act was amended to authorize Treasury and the Secretary of Health and Human Services to enter into an agreement to allow SSA to process information returns. The amendment requires IRS to make available documents agreed upon as necessary for processing information returns.

In 1988, the Commissioners of Internal Revenue and Social Security updated an agreement to share certain data to allow both agencies to improve the accuracy of their records. These data deal largely with the CAWR program, which attempts to reconcile discrepancies in wages reported by employers to IRS on quarterly withholding tax returns and to SSA on annual W-2 forms. However, this agreement also says that IRS will:

“Provide SSA with pertinent IRS audit results and results of other investigations that require adjustments or corrections to prior wage reports or self-employment income returns.”

IRS' underreporter program generates these types of corrections to reported wages. During our review, we found that SSA was interested in receiving these corrections. In a December 1989 letter, SSA followed up on an earlier discussion with IRS on receiving a sample of underreporter results. SSA asked for the sample in order to see whether the corrected wage data would help to correct its accounts. SSA had not accepted such results before December 1989 because of its work load. As of December 1990, IRS had not provided SSA with these data, even though SSA still wants them. IRS officials said they have not provided the data because doing so may not be permitted under section 6103 of the Internal Revenue Code.

We do not agree with IRS' interpretation of the Code. Both section 6103 and the Social Security Act clearly state that IRS will make available to SSA information necessary to process information returns. Consequently, corrected wage data obtained in the underreporter program should be shared with SSA.

Conclusions

In pursuing underreporter cases, IRS detects errors in wage reporting that might not have been disclosed to SSA. SSA officials believe that these data, if shared, can help promote more accurate Social Security payments. IRS has not yet shared these data with SSA because of concerns that doing so may violate laws on disclosing tax data.

We believe IRS has not correctly interpreted the law regulating the disclosure of such tax data to SSA. We believe that the law allows IRS to provide SSA with the corrected wage data found during the underreporter program. Having these data will help SSA to assure that people are paid only the Social Security benefits to which they are entitled.

Recommendation

We recommend that the Commissioner of Internal Revenue provide the SSA with corrected wage data for taxpayers found to have wages that were incorrectly reported to SSA.

Agency Comments and Our Evaluation

In a February 25, 1991, letter (see app. IV), the Commissioner of Internal Revenue agreed with this recommendation and said IRS is working with SSA to determine the specific data to be provided. The Commissioner of Social Security strongly supported this recommendation in a February 22, 1991, letter (see app. V).

Major Types of Information Returns Filed With IRS

Form Number	Type of Transaction Reported
1098	Mortgage interest
1099-A	Acquisition or abandonment of secured property
1099-B	Proceeds from broker and barter exchange transactions
1099-G	Certain government payments
1099-INT	Interest income
1099-DIV	Dividends and distributions
1099-MISC	Miscellaneous income such as rents, royalties, prizes and awards, and nonemployee compensation
1099-OID	Original issue discount
1099-PATR	Taxable distributions received from cooperatives
1099-R	Total distributions from profit sharing, retirement plans, individual retirement accounts, etc.
1099-S	Real estate transactions
1099-SSA	Social Security benefits
1099-RRB	Tier 1, Railroad Retirement benefits
W-2G	Certain gambling winnings
W-2	Wages
W-2P	Annuities, pensions, retirement pay, or IRA payments
5498	Individual Retirement Account information
Various	Foreign documents for income paid to U.S. citizens, such as dividends, interest, etc.
K-1	Shareholders, partners, or beneficiary's share of income, credits, and deductions

AO Sampling Methodology

This appendix describes our sampling approach for selecting unproductive underreporter cases at IRS' Fresno Service Center. Confidence intervals for all estimates cited in the report are presented in this appendix.

Specifically, we requested data as of January 1990 from the Fresno Service Center on the status of all underreporter cases reviewed or to be reviewed. From these data, we identified the universe of potential underreporters of wage and nonemployee compensation income that IRS had reviewed and determined to be unproductive. We then selected stratified random samples from the universes, as shown in table II.1.

Table II.1: Sampling Universes and Sample Sizes

Types of cases closed	Universe size	Sample size	Cases sampled
Wages cases closed			
Without taxpayer contact			
Bad payer cases ^a	15,914	75	50
Other cases	31,298	168	158
After taxpayer contact	5,820	116	101
Subtotal	53,032	359	309
NEC cases closed			
Without taxpayer contact	17,100	119	102
After taxpayer contact	1,577	115	103
Subtotal	18,677	234	205
Totals	71,709	593	514

^aInvolves unproductive cases caused by payers' reporting errors.

We requested randomly selected cases from each sample and reviewed the cases in random number sequence. If a case from a sample was not available for our review or the file was incomplete, we reviewed the next case in the sequence. In reviewing the cases sampled, we developed and used a data collection instrument to gather information about the nature of each case and the reason or reasons each was determined to be unproductive. This data collection instrument allowed us to determine specific reasons why the case was unproductive, as well as to ensure that our samples contained a variety of individual tax returns and amounts of potential tax due.

Statistical information on key estimates in our evaluation and associated confidence intervals is shown in table II.2.

II.2: Key Estimates and Sampling
Reasons for 1987 Unproductive Wage and
Cases at Fresno

Reasons for unproductive cases	Projected number of cases	Key estimates	
		95-percent confidence intervals	
		Upper	Lower
Wages			
Income reported on line not matched	6,946	8,884	5,008
Duplicate and multiple information returns	15,532	17,651	13,413
Miscellaneous	21,022	23,564	18,480
NEC			
Income reported on line not matched	7,616	9,045	6,187
Business income reported as individual income	2,546	3,610	1,482
Miscellaneous	5,192	6,509	3,875

To review the impact of unproductive wage underreporter cases on Social Security accounts, we selected unproductive wage cases that had been closed because of three types of errors and that could most affect the accounts. We analyzed 113 of the 309 cases in which at least one of these errors existed and our review of IRS' case files had been completed as of June 1990. We identified the SSNs of the taxpayer and spouse involved with each case and obtained from SSA the 1987 Social Security Account earnings record for these individuals. We then compared adjustments made by IRS during its underreporter review with the SSA earning records to determine whether the SSA records already had been adjusted. The results of our review are reflected in table II.3.

II.3: Comparison of IRS
Underreporter Results With Social
Security Account Earnings Records

Types of unproductive cases	SSA records reviewed	SSA records overstated	Amount overstated
Multiple information returns submitted	58	21	\$158,891
Reported income did not belong to taxpayer reviewed	41	35	162,960
Payers reported erroneous data	14	10	46,909
Total	113	66	\$368,760

S Tax Forms and Schedules Discussed in this Report

Form 1040, U.S. Individual Income Tax Return—Used by taxpayers who have incomes over \$50,000 or itemize deductions.

Form 1040A, U.S. Individual Income Tax Return—Used by taxpayers who have income from wages, unemployment compensation, interest, and dividends under \$50,000 and who do not itemize deductions.

Form 1040EZ, U.S. Individual Income Tax Return—Used by taxpayers who are single, under 65 years of age, and have income from wages or less than \$400 of taxable interest.

Form 1040X, Amended U.S. Individual Income Tax Return—Used by taxpayers to correct Form 1040, Form 1040A, and Form 1040EZ.

Form 2106, Employee Business Expense—Used by taxpayers who are employees deducting expenses attributable to the taxpayer's job.

Schedule E, Supplemental Income Schedule—Used by taxpayers to report business income from rents, royalties, partnerships, and S corporations.

Schedule F, Farm Income and Expenses—Used by taxpayers to report farm income and expenses.

Comments From the Internal Revenue Service



COMMISSIONER

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

FEB 25 1991

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled, "Tax Administration: IRS Can Improve Its Program to Find Taxpayers Who Do Not Report All Their Income".

We generally agree with the report recommendations to improve our document matching programs. The IRS is constantly looking for ways to improve our Underreporter Program and to reduce the number of "unproductive cases" through efficient computer matching and through the effective use of all available information. We have already made improvements to our Tax Year 1988 program which is currently underway and to our Tax Year 1989 program which will begin shortly.

The Underreporter Program is an integral part of IRS compliance activities and has served to bolster a declining audit presence. Through an effective balance of taxpayer education, strategic planning, quality improvement initiatives and tax systems modernization, including our Automated Underreporter project which is being piloted this year, we have established both short-term and long range goals for improving this program throughout the 1990's.

Detailed comments regarding the report recommendations are enclosed.

Best regards.

Sincerely,

for/ Michael J. Mungley
Fred T. Goldberg, Jr.

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX ADMINISTRATION: IRS CAN IMPROVE ITS PROGRAM TO
FIND TAXPAYERS WHO DO NOT REPORT ALL THEIR INCOME"

Recommendation:

Modify the computer match to search for income on as many tax return lines as possible without inadvertently screening out productive cases.

Comment:

We agree. The IRS continually looks for ways to improve our computer matching and screening capabilities to reduce the number of unproductive cases. A recent study at our Kansas City Service Center analyzed erroneous taxpayer reporting tendencies to identify additional matching requirements. The following examples illustrate recent improvements which have been incorporated into the matching criteria.

The match criteria for the Tax Year (TY) 1988 Underreporter Program which is currently underway was enhanced to computer-screen the following wage discrepancies:

- . Underreported wages and overreported pensions;
- . Underreported wages and overreported unemployment compensation for Form 1040EZ filers only;
- . Overreported wages and underreported pensions;
- . Overreported wages and underreported unemployment compensation for Form 1040EZ filers only;
- . Overreported wages and underreported miscellaneous income (line 22);
- . Overreported wages and underreported gross receipts (NEC, Medical, Fishing, etc.)

The TY 1989 program which will begin shortly will be enhanced by:

- . Additional transcription of the Schedule F for matching crop insurance proceeds and commodities credit certificates.
- . Computer screening of underreported wages and overreported interest.

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In addition, under our 1991 Annual Business Plan we are undertaking a nationally coordinated effort to further reduce the number of unproductive cases involving non-employee compensation.

Recommendation:

Modify the computer match to use SSA's corrected wage data to identify when employers submit multiple information returns for the same taxpayer.

Comment:

We agree that SSA's corrected wage data could be used to reduce the number of unproductive cases. However, the corrected wage data must be received timely, be specific as to tax year and be in a usable format. We will use all known duplicate documents which are received timely to eliminate unproductive underreporter cases, especially Forms W-2. For example, the corrected wage information mentioned in the GAO report should have been available by February 1, 1991 in order to eliminate duplicate W-2s in the TY 1989 Underreporter Program. We will work closely with SSA to ensure that the duplicate data is in a usable format and marked so IRS can determine the Tax Year and which W-2 should be eliminated.

Recommendation:

Modify the computer match to count all amounts of income that taxpayers report on amended tax returns.

Comment:

Amended returns' tax changes are considered before underreported cases are created to the extent possible. For TY 1987 and subsequent years, the match criteria compares the potential tax change for the underreported income to the amended return's tax change to determine if it should be included in the underreporter program inventory.

To effectively implement GAO's recommendation, the Form 1040X would have to be redesigned to include a predesignated line for adjustments and the changes by income type would have to be transcribed during service center processing. The cost of this operation must be weighed against the cost of tax examiners manually screening the amended tax returns.

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Recommendation:

Notify taxpayers who provide their Social Security number to payers of business income to begin providing their business' tax identification number.

Comment:

IRS recognizes the need to educate businesses on the importance of providing their correct tax identification numbers to payors.

Since TY 1984, the Form W-9 "Request for Taxpayer Identification Number and Certification" instructs taxpayers to properly identify the correct entity for whom payments will be made and to enter the Taxpayer Identification Number (TIN) in the appropriate box. For individuals and sole proprietors the TIN is their SSN. For other entities, corporations and partnership, etc., it is the Employer Identification Number.

Effective for TY 1986, the Publication 1383 "The Correspondence Process (Income Tax Accounts)" was included with all Underreporter Program CP-2000 Notices which informs taxpayers how to avoid unnecessary notices from IRS by making sure that the correct taxpayer identification number appears only on each account.

Effective for TY 1988, information returns for non-corporate businesses are included in the program as a result of our newly implemented BMF-IRP matching for sole proprietors.

For our TY 1990 program, we will again remind taxpayers to submit a new W-9 informing the payer of the correct taxpayer identification number when income belongs to a corporation or partnership.

Recommendation:

Modify the management information system for the underreporter program to provide specific reasons why case were unproductive. This information, when available, should be used to monitor program results and further improve the matching process.

Comment:

IRS recognizes the need to improve our management information system and we are presently addressing this issue as part of the Underreporter Program Process Code System. We plan to expand the use of reason codes to specifically identify the forms and lines where the income was reported on the tax return

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which caused it to be "screened out" or "no changed". This additional data will assist in the selection of the most productive cases for a given tax year and improve the match criteria for subsequent years.

Recommendation:

Provide the Social Security Administration with corrected wage data for taxpayers found to have wages that were incorrectly reported to SSA.

Comment:

Within the present framework of the disclosure provisions of section 6103 of the Internal Revenue Code (IRC), wage change data from the underreporter program can be released to SSA. However, other types of information available to SSA depend on the activities for which the data will be used. We will work closely with SSA to provide the information needed within the framework of IRC 6103.

Comments From the Social Security Administration



THE COMMISSIONER OF SOCIAL SECURITY
BALTIMORE, MARYLAND 21235

FEB 22 1991

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
441 G Street, N.W. Room 3858
Washington, D.C. 20548

Dear Mr. Fogel:

As requested, enclosed are our comments on your draft report, "Tax Administration: IRS Can Improve Its Program to Find Taxpayers Who do Not Report All Their Income." We appreciate the opportunity to comment. Let us know if we may be of further assistance.

Sincerely,

A handwritten signature in cursive script, appearing to read "G. King".

Gwendolyn S. King
Commissioner
of Social Security

Enclosure

cc:
Mr. Richard Kusserow

COMMENTS OF THE SOCIAL SECURITY ADMINISTRATION ON THE GENERAL
ACCOUNTING OFFICE DRAFT REPORT, "TAX ADMINISTRATION: IRS CAN
IMPROVE ITS PROGRAM TO FIND TAXPAYERS WHO DO NOT REPORT ALL THEIR
INCOME"

We strongly support the recommendation that the Commissioner of Internal Revenue provide the Social Security Administration (SSA) with corrected wage data for taxpayers found to have wages that were incorrectly reported to SSA.

In a Memorandum of Understanding (MOU) on Combined Annual Wage Reporting signed on January 22, 1991, the Internal Revenue Service (IRS) agrees to provide SSA with pertinent IRS audit results or results of other investigations that require adjustments to SSA's earnings records. We believe that the MOU provides IRS with the authority to disclose information from the underreporter program and we look forward to working with them on this issue.

We do not have comments regarding the other recommendations.

Major Contributors to This Report

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