United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

November 2007

TAX ADMINISTRATION

Costs and Uses of Third-Party Information Returns

Accountability * Integrity * Reliability

GAO-08-266

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TAX ADMINISTRATION

Costs and Uses of Third-Party Information Returns

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Highlights

Highlights of GAO-08-266, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

One proven approach for improving tax compliance is information reporting to the Internal Revenue Service (IRS) by third parties about taxpayers' income and expenses. IRS matches information returns with taxpayers' income tax returns to see if taxpayers have filed returns and reported all their income. The administration's fiscal year 2008 budget proposed requiring information reporting on merchant payment card reimbursements and on certain payments to corporations, raising an estimated $18.4 billion over 10 years.

This report's objectives are to (1) identify, using case studies, the compliance costs of existing information reporting; (2) determine the kinds of third-party compliance costs that may result from the two budget proposals and options for mitigating the costs; and (3) determine IRS's ability to process and use additional information returns.

GAO did nongeneralizable structured interviews with four payers volunteering information and with five companies filing a sizable percentage of all information returns. GAO's work also included reviewing studies and documentation and contacting other government and nongovernment parties.

What GAO Recommends

GAO makes no recommendations in this report. IRS provided technical comments, which GAO incorporated as appropriate.

To view the full product, including the scope and methodology, click on GAO-08-266. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

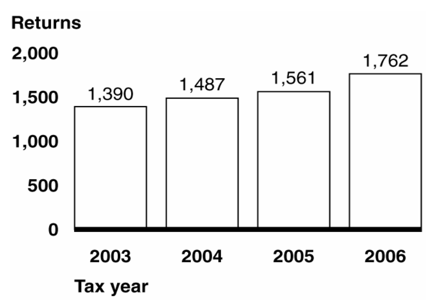
What GAO Found

In nine case studies, filers of information returns told GAO that existing information return costs were relatively low. One small business employing under five people told GAO of possibly spending 3 to 5 hours per year filing Form 1099 information returns manually, using an accounting package to gather the information. Two parties selling services reported prices for preparing and filing Forms 1099 with IRS of about $10 per form for 5 forms to about $2 per form for 100 forms, with one of them charging about $.80 per form for 100,000 forms. As expected, unit prices for services provided to payers by selected software vendors, service bureaus, and return preparers decreased as the number of forms handled increased.

The two information reporting proposals studied would impose new compliance costs, some of which could be mitigated. For payment card reimbursements, compliance costs would include (1) merging separately stored taxpayer and merchant identification numbers, especially in the case of multiple locations or franchises; and (2) more generally, new systems and added service requirements. Mitigations could include (1) having the reporting party be as close as possible to the merchant in a payment or reporting chain and (2) extending current systems and procedures that, for instance, might already generate and report related data used for other purposes. For payments to corporations for services, payer compliance costs would include, for example, additional bookkeeping, and mitigations could include limiting information return recipients to only some corporations.

IRS already receives and handles a growing number of information returns, over 1.7 billion for tax year 2006. According to IRS officials, IRS uses about 90 percent of potentially usable information returns in its matching efforts for individual taxpayers. IRS pursues millions of discrepancies, including both underreporting of income and failure to file tax returns, discovered through its matching efforts. According to IRS officials, millions of others are not pursued because of resource constraints. For the two proposals studied, IRS budgeted $11.8 million in programming and start-up costs for fiscal year 2008, with another $16.8 million expected in administrative implementation costs after 2008. It did not estimate future enforcement costs.

IRS Receipt of Information Returns (Numbers in Millions)



Source: IRS Data Books for 2003 through 2005 and IRS for 2006.

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United States Government Accountability Office
Washington, DC 20548

November 20, 2007

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

The tax year 2001 gross tax gap—the difference between what taxpayers should have paid and what they actually paid—was an estimated $345 billion. One proven approach for improving tax compliance is information reporting to the Internal Revenue Service (IRS) by third parties about taxpayers' income and expenses. The administration's fiscal year 2008 budget contained information reporting proposals estimated to increase federal revenue by about $29 billion over 10 years. Two of the proposals would expand information reporting to cover (1) reimbursements by banks to merchants for the merchants' payment card receipts and (2) payments by businesses to corporations for services the corporations provided, together raising an estimated $18.4 billion over 10 years.

IRS seeks to verify compliance by trying to compare the income or expenses reported by third parties to the income or expenses taxpayers report on their tax returns to see if taxpayers have filed returns and reported all their income. Like all information reporting, the proposals would assign some of the costs of tax administration to private sector parties who would have to file information reports with IRS. The administration did not estimate the costs of the information reporting proposals to third-party payers. In addition, questions have been raised about IRS's ability to process and use additional information returns. You asked us for more details on the effects of expanding information return reporting requirements.

This report's objectives are to

- identify the compliance costs associated with existing information reporting requirements as reported by selected case study payer organizations, software vendors, service bureaus that transmit information returns to IRS on behalf of payers, and return preparers;
- determine the kinds of third-party compliance costs that may result from two information reporting proposals—merchant payment card

reimbursements and payments to corporations—and any options for mitigating the costs; and

- determine IRS's ability to process and use additional information returns.

To identify compliance costs reported in selected cases, we used (1) structured interviews, others' studies, and other interviews about factors influencing costs; and (2) Web sites showing price information. We used structured interviews to see how much selected payers spend in-house on information reporting and how much selected parties charge for it. We interviewed four organizations volunteered through International Accounts Payable Professionals or the National Federation of Independent Business, an organization of small businesses that is on record as finding the information reporting proposals we are studying to be troublesome to small businesses. Also, we selected five companies from lists of vendors, IRS-approved e-filers, and Information Reporting Program Advisory Committee members, enough to include representatives of software vendors, service bureaus, and return preparers and cover a sizable percentage of all information returns. These nine case studies provide examples of costs but are not to be generalized to the entire population. We also examined Web sites of the five vendors, service bureaus, and return preparers that we interviewed and of others appearing on two IRS lists of e-filers.

To determine the kinds of third-party compliance costs that may result from the two information reporting proposals and any options for mitigating the costs, we reviewed studies and documentation, interviewed government and nongovernment parties, and analyzed compliance costs and mitigations related to any overlap among the proposals and an expanded broker proposal. Nongovernment contacts included eight national organizations representing small businesses, banking and electronic transactions industries, and other interests; and companies in the payment card industry. For the payments-to-corporations proposal, which is closer to current requirements than the payment card proposal is, we used the structured interviews for the first objective described earlier for further insights into the compliance costs involved. Our lists of compliance costs and mitigations may not be exhaustive, and we did not evaluate (1) trade-offs that policymakers will have to make among items on the lists or (2) projected benefits from the proposals. Mitigation ideas are possible ways to reduce, not eliminate, costs, and their viability depends on their own costs and benefits and accompanying facts and circumstances.

To determine IRS's ability to process and use additional information returns, we analyzed how IRS uses information returns and how many information returns IRS processes and sends through its matching process. We also asked how IRS checks that all information returns that should be filed are filed. Finally, we interviewed IRS officials on how they would accommodate additional information returns and assessed related IRS costs and plans. We determined that the data used in this report to describe the growing number of information returns filed and the disparity between the numbers of tax underreporter and nonfiler cases identified and the numbers pursued are sufficiently reliable for the purposes of the report; we determined this after interviewing IRS officials and reviewing the information's reasonableness against other information we had.

We did our work from April 2007 through October 2007 in accordance with generally accepted government auditing standards. On November 6, 2007, we briefed your staff on the results of our work. This report conveys the information provided during that briefing. A copy of the briefing document with slight revisions is included in appendix I.

Results

In our nine case studies, filers of information returns told us that existing information return costs, both in-house and for external payments, were relatively low. In-house compliance costs included the costs of getting taxpayer identification numbers (TIN), buying software, tracking reportable payments, filing returns with IRS, and mailing copies to taxpayers. One small business employing under five people told us of possibly spending 3 to 5 hours per year filing Form 1099 information returns manually, using an accounting package to gather the information. An organization with more than 10,000 employees estimated spending less than .005 percent of its yearly staff time on preparing and filing Forms 1099, including recordkeeping. Two external parties reported prices for preparing and filing Forms 1099 with IRS of about $10 per form for 5 forms to about $2 per form for 100 forms, with one of them charging about $.80 per form for 100,000 forms. As expected, unit prices for services provided to payers by selected software vendors, service bureaus, and return preparers decreased as the number of forms handled increased.

New information reporting requirements for payment card reimbursements and payments to corporations would impose new compliance costs, some of which could be mitigated. For payment card reimbursements, compliance costs would include (1) merging separately stored TINs and merchant identification numbers, especially in the case of multiple locations or franchises; and (2) more generally, new systems and added service requirements. Mitigations could include (1) having the reporting party be as close as possible to the merchant in a payment or reporting chain and (2) extending current systems and procedures that, for instance, might already generate and report related data for other purposes.

For payments to corporations for services, payer compliance costs would include, for example, additional bookkeeping and postage, as well as the need for TIN collection and distinguishing between payments for goods or for services. Mitigations could include using or extending current systems, limiting information return recipients to only some corporations, and grandfathering ongoing relationships for TIN collection and other purposes or specifying a lead time for collecting information on them.

IRS already receives and handles a growing number of information returns, over 1.7 billion for tax year 2006. According to IRS officials, after correction, about 98 percent of these information returns are potentially usable for matching purposes. IRS uses about 90 percent of these potentially usable information returns in its matching efforts for individual taxpayers. The majority of the remaining 10 percent of information returns cannot be used for individual matching efforts because they are associated with business, not individual, tax returns. IRS pursues millions of discrepancies, including both underreporting of income and failure to file tax returns, discovered through its matching efforts. According to IRS officials, millions of others are not pursued because of resource constraints.

For the two proposals we studied, IRS budgeted $11.8 million in programming and start-up costs for fiscal year 2008, with another $16.8 million expected in future administrative implementation costs, although for the payments-to-corporations proposal, IRS said its cost estimates could vary by an additional several million dollars. By design, it did not estimate future enforcement costs because of uncertainty over whether legislation would pass and how it would be implemented; for example, it did not cost out the expected hundreds of staff years needed to use payments-to-corporations information returns. Also for this proposal, it conservatively estimated 60 million forms arriving annually, saying the actual number could range into the billions. IRS will be in a better position to estimate how many information returns, including those in paper form, will be arriving if specific legislation is enacted. Any enacted proposals would require IRS to address their benefits and costs and minimize their burden on the public before the Office of Management and Budget approves the information collection.

Agency Comments and Our Evaluation

We provided a draft of the briefing document in appendix I to the Acting Commissioner of Internal Revenue for review and comment. IRS provided technical written comments, which we incorporated as appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Secretary of the Treasury; the Acting Commissioner of Internal Revenue; and other interested parties. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staffs have any questions, please contact me at (202) 512-9110 or at whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report were Kevin Daly, Evan Gilman, George Guttman, Jyoti Gupta, Lawrence Korb, and Edward Nannenhorn.

James R. White
Director, Tax Issues
Strategic Issues

Appendix I: Briefing Slides

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TAX ADMINISTRATION
Costs and Uses of Third-Party Information Returns

November 6, 2007 Briefing to the
Senate Committee on Finance

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Briefing Contents

- Introduction
- Objectives
- Results in Brief
- Scope and Methodology
- Background
- Information Reporting Costs of Case Study Organizations
- Payment Card Reimbursements
- Payments to Corporations
- The Internal Revenue Service's (IRS) Ability to Process and Use Information Returns

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Costs and Uses of Third-Party Information Returns

Introduction

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Introduction

- The tax year 2001 gross tax gap--the difference between what taxpayers should have paid and what they actually paid--was an estimated $345 billion.

- One proven approach for improving tax compliance is information reporting to IRS by third parties about taxpayers' income and expenses. IRS seeks to verify compliance by trying to compare the income or expenses reported by third parties to the income or expenses taxpayers report on tax returns.

- The administration's fiscal year 2008 budget contained information reporting proposals estimated to increase federal revenue by about $29 billion over 10 years. Two of the proposals would expand information reporting to cover

    - reimbursements by banks to merchants for the merchants' payment card receipts and

    - payments by businesses to corporations for services the corporations provided.

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Introduction (Cont.)

- Like all information reporting, the proposals would assign some of the costs of tax administration to private sector parties who would have to file information reports with IRS.
- The administration did not estimate the costs of the information reporting proposals to third-party payer organizations, or payers, making various kinds of payments and filing information returns.
- In addition to the compliance costs of the proposals, questions have been raised by some opponents of the proposals about IRS's ability to process and use additional information reports.
- The Senate Committee on Finance asked us for more information on the effect of expanding information return reporting requirements.

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Objectives

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Objectives

- Identify the compliance costs associated with existing information reporting requirements as reported by selected case study payer organizations, software vendors, service bureaus that transmit information returns to IRS on behalf of payers, and return preparers.
- Determine the kinds of third-party compliance costs that may result from two information reporting proposals—payments to corporations and merchant payment card reimbursements—and any options for mitigating the costs.
- Determine IRS's ability to process and use additional information returns.
- To address our objectives, we did nongeneralizable structured interviews with five companies appearing on various lists and filing a sizable percentage of all information returns and with four payers volunteered by associations; we also reviewed studies and documentation and contacted IRS and other government and nongovernment parties.

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Results in Brief

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Results in Brief

Information Reporting Costs of Case Study Organizations

- In our nine case studies, filers of information returns told us that existing information return costs, both in-house and for external payments, were relatively low.
    - One small business employing under five people told us of possibly spending 3 to 5 hours per year filing Form 1099 information returns manually, using an accounting package to gather the information.
    - An organization with more than 10,000 employees estimated spending less than .005 percent of its yearly staff time on preparing and filing Forms 1099, including recordkeeping.
    - Two external parties reported prices for preparing and filing Forms 1099 with IRS of about $10 per form for 5 forms to about $2 per form for 100 forms, with one of them charging about $.80 per form for 100,000 forms.

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Results in Brief (Cont.)

- As expected, unit prices for services provided by selected software vendors, service bureaus, and return preparers decreased as the number of forms handled increased.

Information Reporting Proposals—Compliance Costs and Mitigations

- New information reporting requirements for payment card reimbursements and payments to corporations would impose new compliance costs, some of which could be mitigated.
    - For example, for payment card reimbursements, compliance costs would include (1) merging separately stored taxpayer and merchant identification numbers, especially in the case of multiple locations or franchises; and (2) more generally, new systems and added customer service requirements.
    - Mitigations could include (1) having the reporting party be as close as possible to the merchant in a payment or reporting chain and (2) extending current systems and procedures that, for instance, might already generate and report related data used for other purposes.

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Results in Brief (Cont.)

IRS's Ability to Process and Use Information Returns

- According to IRS, after correction, about 98 percent of the information returns it receives are potentially usable for matching purposes; IRS uses about 90 percent of these potentially usable information returns in its matching efforts for individual taxpayers; of the remaining 10 percent of information returns, the majority cannot be used for individual matching efforts because they are associated with business, not individual, tax returns.
  - After going through the matching process, IRS pursues millions of discrepancies above certain dollar thresholds; according to IRS officials, millions of other discrepancies above the thresholds are not pursued because of resource constraints.
- For the two information reporting proposals GAO studied, IRS budgeted $11.8 million in programming and start-up costs for fiscal year 2008, with another $16.8 million expected in future administrative implementation costs.
  - IRS did not estimate future enforcement costs because of uncertainty over whether legislation would pass and how it would be implemented; for example, it did not cost out the expected hundreds of staff years needed to use payments-to-corporation information returns.
- Any enacted proposals would require IRS to address their benefits and costs and minimize their burden on the public before the Office of Management and Budget approves the information collection.

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Costs and Uses of Third-Party Information Returns

Scope and Methodology

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Scope and Methodology

- Objective 1: used (1) structured interviews, others' studies, and other interviews about factors influencing costs; and (2) Web sites showing price information.
    - Used structured interviews to see how much selected (1) payer organizations spend in-house on information reporting and (2) software vendors, service bureaus, and return preparers charge for information reporting.
        - Interviewed four organizations volunteered through International Accounts Payable Professionals or the National Federation of Independent Business, an organization of small businesses that is on record as finding the information reporting proposals we are studying to be troublesome to small businesses.

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Scope and Methodology (Cont.)

- Selected five companies from lists of vendors, IRS-approved e-filers, and Information Reporting Program Advisory Committee members, enough to include representatives of software vendors, service bureaus, and return preparers and cover a sizable percentage of all information returns.

- These nine case studies provide examples of costs but are not to be generalized to the entire population; however, they do provide insights from the perspective of organizations of different sizes and from different industries and of organizations filing their own information returns and those filing on behalf of others.

- Examined Web sites of the above five vendors, service bureaus, and return preparers we interviewed and others appearing on two IRS lists of e-filers.

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Scope and Methodology (Cont.)

- Objective 2: for each of the two information reporting proposals, reviewed studies and documentation on compliance costs to implement the proposals and ways to mitigate those compliance costs; interviewed IRS, the Department of the Treasury, and nongovernment parties about compliance costs and mitigations; and analyzed compliance costs and mitigations related to any overlap among the proposals and an expanded broker proposal.

    - Nongovernment contacts included eight national organizations representing small businesses, banking and electronic transactions industries, and other interests; and companies in the payment card industry.

    - Limitations: Our lists of compliance costs and mitigations may not be exhaustive, and we did not evaluate (1) trade-offs that policymakers will have to make among items on the lists or (2) projected benefits from the proposals; mitigation ideas are possible ways to reduce, not eliminate, costs, and their viability depends on their own costs and benefits and accompanying facts and circumstances.

- For the payments-to-corporations proposal, which is closer to current requirements than the payment card proposal is, we used the structured interviews for objective 1 for further insights into compliance costs involved.

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Scope and Methodology (Cont.)

- Objective 3: analyzed how IRS uses information returns and how many information returns IRS processes and sends through the matching process. In addition,
    - asked how IRS checks that all information returns that should be filed are filed, and
    - interviewed IRS officials on how they would accommodate additional information returns and assessed related IRS costs and plans.
- We determined that the data used in this report to describe the growing number of information returns filed and the disparity between the numbers of tax underreporter and nonfiler cases identified and the numbers pursued are sufficiently reliable for the purposes of the report; we determined this after interviewing IRS officials and reviewing the information's reasonableness against other information we had.
- We did our work from April through October 2007 in accordance with generally accepted government auditing standards.

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Costs and Uses of Third-Party Information Returns

Background

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Background

How Information Reporting Works and Why It Is Important

- Information reporting involves third-party payers, such as employers or banks, filing returns with IRS and taxpayers after each calendar year that provide information on a variety of taxpayers' transactions and payments, such as wages and miscellaneous income.
  - IRS validates the accuracy of the names and taxpayer identification numbers (TIN) on the information returns; if accurate TINs are not provided, IRS can often require third parties to withhold taxes from payments to the taxpayers, a procedure known as backup withholding.
  - IRS tries to match information from information returns filed by third parties against taxpayers' income tax returns to see if taxpayers have filed returns and reported all their income.

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Background (Cont.)

- As the next slide shows, voluntary reporting compliance is substantially higher for income subject to withholding or information reporting than for other income.
    - For example, for wages and salaries, which are subject to withholding and substantial information reporting, taxpayers have consistently misreported only an estimated 1 percent of their income.
    - For income with little or no information reporting, the tax year 2001 estimated percentage was about 54 percent.

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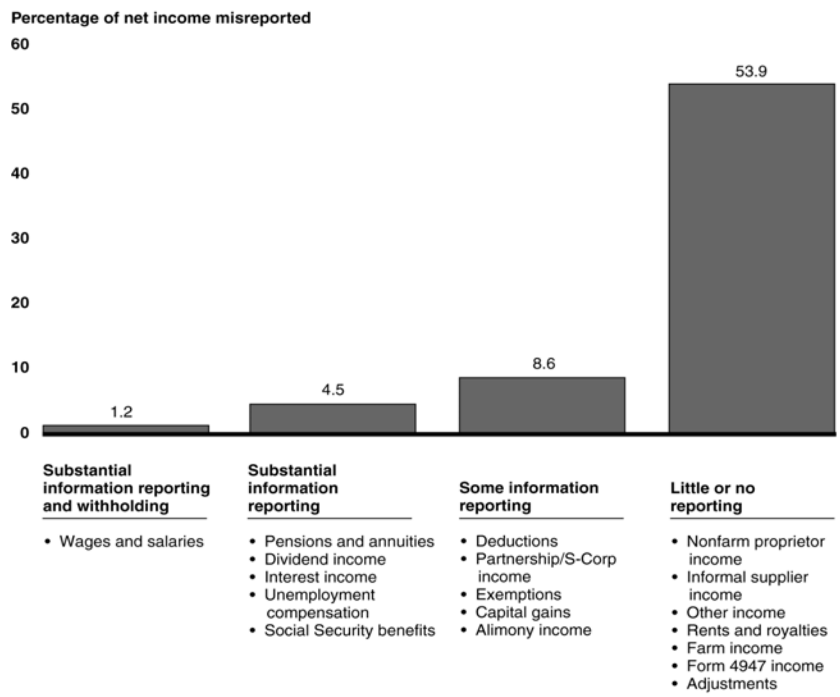
Background (Cont.)

Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting, Tax Year 2001



Source: IRS.

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Background (Cont.)

Benefits and Costs of Information Reporting

- Improved compliance with the tax laws due to information reporting increases tax revenue. Increased revenue is not itself a benefit to society as a whole because the increased revenue simply transfers resources from the private sector to the public sector. Benefits depend on what is done with the revenue. The increased revenue could be used to reduce tax rates, increase spending, or reduce deficits.

- Increased compliance could provide benefits to society that include:

  - increased economic growth if, for example, the increased revenue is used to reduce large, long-term federal budget deficits;

  - increased taxpayers' perceptions of the fairness of the tax system; and

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Background (Cont.)

- increased economic efficiency by, for example, “leveling the playing field” for business, making it less likely that resources will be shifted into less productive activities simply because these activities present greater opportunities for noncompliance.

- The costs of information reporting include the in-house compliance costs of third parties, such as recordkeeping and employee time; third-party external costs, such as their payments to vendors and return preparers; and the resources used by IRS to process and match the returns.
- In line with this discussion on benefits and costs, the Paperwork Reduction Act of 1995 requires IRS to get Office of Management and Budget approval that the benefits of collecting any new information outweigh the costs.

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Costs and Uses of Third-Party Information Returns

Information Reporting Costs of Case Study Organizations

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Information Reporting Costs of Case Study Organizations

Third-Party Compliance Costs

- To comply with information reporting requirements, third parties would incur costs internally or pay external parties.
  - In-house costs may involve additional recordkeeping costs beyond normal recordkeeping costs related to running a business, as well as the costs of preparing and filing the information returns themselves.
  - If the third parties go outside their organizations for help, they would incur out-of-pocket costs to buy software or pay for others to prepare and file their returns.

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Information Reporting Costs of Case Study Organizations (Cont.)

For Case Study Entities Reporting Current Cost Information to Us, Their IRS Form 1099 Costs Were Relatively Small

- These case studies provided examples of in-house and external costs but are not to be generalized to the entire population.

In-house Costs

- In our case study payer organizations, current compliance costs included the costs of getting TINs, buying software, tracking reportable payments, filing returns with IRS, and mailing copies to taxpayers; organizations may file up to 16 kinds of Forms 1099, but the organizations we studied filed mostly Forms 1099-MISC reporting miscellaneous income, a category that includes nonemployee compensation.
    - One organization with employees numbering in the low thousands estimated that its current costs of preparing and filing a couple hundred Forms 1099, which include recordkeeping and distinguishing goods from services, are a minimal addition to its normal business costs.

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Information Reporting Costs of Case Study Organizations (Cont.)

- An organization with more than five times the employees and Forms 1099 of the last organization estimated spending less than .005 percent of its yearly staff time on preparing and filing the 1099 forms, including recordkeeping.
- One business with fewer than 5 employees and Forms 1099 but with people knowledgeable about accounting told us of possibly spending 3 to 5 hours per year on filing 1099 forms manually, using an accounting package to gather the information.
- Another small business--one employing about 20 to 25 people and filing almost as many Forms 1099--told us of spending a little over an hour a year retyping and filing 1099 forms generated by its accounting package.

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Information Reporting Costs of Case Study Organizations (Cont.)

Payments to External Parties

- Unit prices for services provided by outside organizations we examined decreased as the number of forms handled increased.
  - Selected software vendors, service bureaus, and return preparers, and various Web sites informed us that prices varied depending on the number of forms filed and the services performed.
  - For one outside organization, prices for printing, filing with IRS, and mailing decreased from between $3 and $4 per form for 5 forms, subject to an overall fixed minimum of under $100, to well under $1 per form for doing 100,000 forms.
    - Prices for just filing with IRS fell to $.01 each after the first few thousand 1099 forms.

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Information Reporting Costs of Case Study Organizations (Cont.)

- Prices from one vendor for off-the-shelf software for organizations to do their own preparation, filing, and mailing were in the low hundreds of dollars the first year and less afterwards for yearly updates.

- Prices from two other companies for preparing and filing Forms 1099 ranged from about $10 per form for 5 forms to about $2 per form for 100 forms, with one of them charging about $.80 per form for 100,000 forms.

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Information Reporting Costs of Case Study Organizations (Cont.)

Relationship to Studies That Have Been Done

- This relationship of price to size for entities we studied is consistent with what studies that we have seen show about the role of fixed costs and economies of scale in complying with the tax code; we are familiar with no similar studies of information returns.
    - According to Slemrod and Bakija, studies consistently found that the smaller the firm, the larger the cost of complying with the tax system per dollar of various measures of the size of the firm. (See Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes*, 3rd ed. (Cambridge, Mass.: The MIT Press, 2004).

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Payment Card Reimbursements

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Payment Card Reimbursements

Description of Payment Card Reimbursement Proposal

- “Merchant acquiring banks” would report to IRS the gross reimbursement payments made to merchants in a calendar year.
  - Merchant acquiring banks (henceforth called banks) include organizations that process card payments for merchants that accept payment cards.
  - Payment cards include credit and debit cards.
  - The proposal was not detailed, with the overall cost and number of affected information return filers unknown and any resulting legislation still needing regulations to implement it.
  - Under the proposal, IRS and the Department of the Treasury could make exceptions from the requirements where compliance costs of information reporting outweighed benefits from improved compliance.

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Payment Card Reimbursements (Cont.)

- IRS would compare reported amounts to the gross receipts that merchants reported on their tax returns.
    - When reimbursements differ from gross receipts in a way that indicates that income might be underreported, IRS could use the information in selecting and conducting audits of taxpayers.

Revenue Estimate for the Payment Card Reimbursement Proposal

- The administration's fiscal year 2008 budget estimated that the payment card reimbursement proposal would raise about $10.7 billion over 10 years.

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Payment Card Reimbursements (Cont.)

Compliance Costs

- Merging separately stored TINs and other merchant information would add compliance costs, especially in the case of multiple locations or franchises.
    - For example, different hotels in the same chain may have the same TIN but different merchant identification numbers for payment card purposes.

Mitigations

- The proposal could be made flexible so that parties reporting to IRS could be banks or an unknown number of other entities, such as parent corporations, that are as close as possible to the merchant in the payment or reporting chain and, thus, knowledgeable about the merchant; regulations could assure that the party actually (1) paying the merchant or (2) preparing the report on which the payment is based is the one reporting to IRS.

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Payment Card Reimbursements (Cont.)

Compliance Costs

- Costs would be incurred if the reporting requires that banks and others have their current merchants get TINs certified on an IRS form.

Mitigations

- Current merchant accounts that have already supplied uncertified TINs could be grandfathered, although this may mean that many could be grandfathered for many years or even indefinitely.

- Certified TINs could be required at a specific future date, but TINs could change and need to be monitored over time.

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Payment Card Reimbursements (Cont.)

Compliance Costs

- Costs would be incurred if procedures and systems are established to insert backup withholding into ongoing, complicated relationships to increase the probability of getting accurate TINs.

Mitigations

- Legislation could be passed without a backup withholding provision, but this mitigation would limit the potential effectiveness of the proposal and risk losing revenue due to invalid TINs.

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Payment Card Reimbursements (Cont.)

Compliance Costs

- Banks and others may need to field questions when cash versus accrual and calendar year versus fiscal year information reporting do not match merchants' accounting systems and uncertainty is created.

Mitigations

- Since
  - IRS is not planning an exact match anyway but only a trigger for questions,
  - almost all entities are on the calendar year basis,
  - large percentages are on the cash basis, and
  - accrual taxpayers might be more sophisticated than others,

  IRS could let banks and others know that, possibly by analyzing multiple years' data, it would work from the knowledge that years can differ for tax and accounting purposes.

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Payment Card Reimbursements (Cont.)

Compliance Costs

- Because transactions involve cash backs, returns, tips, fees, gift cards, and other items, payment reimbursements may not match merchant receipts, creating costs for banks and others to the extent they have to address these discrepancies.

Mitigations

- Since IRS is not planning an exact match anyway, it could announce it was developing industry norms of net-to-gross ratios to evaluate information, although norms may not be foolproof or always possible.
- IRS could deal with part of the compliance cost by modeling the reporting form after the Form 1099-B for brokers and giving the information return preparer a choice on the form for gross or net information, although this mitigation could create inconsistencies across payers.
- To the extent that gross and net amounts might even out over time, concern could center on any that do not.

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Payment Card Reimbursements (Cont.)

Compliance Costs

- Information on TINs in addition to merchant identification numbers flowing through the payment card system would increase the amount of confidential information that could be disclosed if a security breach occurred, creating clean-up and customer relations costs.
- Legal liabilities related to payment card operating rules may change.

Mitigations

- The number of links in banks' and others' systems between TINs, merchant identification numbers, and merchant payment card receipts could be minimized.
- Various parties could be involved in considering legislative and regulatory details.

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Payment Card Reimbursements (Cont.)

Compliance Costs

- Overall, because of issues mentioned previously, software, hardware, systems, processes, and training would need to be developed, involving an uncertain amount of time and cost; banks and others would need to add service people to handle questions and inadvertent errors.

Mitigations

- To limit overall compliance costs, banks and others could extend systems and procedures already in place that, for instance, might already generate and report related data used for other purposes.

- Congress or IRS could provide adequate lead time to allow banks and others to develop any needed software, etc.

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Costs and Uses of Third-Party Information Returns

Payments to Corporations

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Payments to Corporations

Description of Payments-to-Corporations Proposal

- Today, businesses paying corporations for services generally do not have to send IRS information returns covering the payments.
  - Payments to corporations are generally not covered by an overall requirement that taxpayers paying a total of $600 or more for services in the course of a trade or business send IRS an information return showing the dollar amount and the payee.
- Most payments requiring information reporting today are subject to backup withholding if the payee has not provided a valid TIN.
- To address compliance issues and improve voluntary compliance, the administration proposed requiring information returns for payments to corporations for services totaling $600 or more in a calendar year.
  - It did not specify much detail.

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Payments to Corporations (Cont.)

Revenue Estimates for the Payments-to-Corporations Proposal

- The administration's fiscal year 2008 budget estimated that the payments-to-corporations proposal would raise about $7.7 billion over 10 years, a greater amount than the Joint Committee on Taxation's revenue estimate of $1.7 billion.
  - The Joint Committee's estimate was footnoted to say that it was very preliminary and subject to change upon clarification of the proposal.

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Payments to Corporations (Cont.)

Our Previous Work

- In 1991, we suggested that Congress needed to pass legislation to require that payments to corporations be reported on information returns (GAO/GGD-91-118).
- In 1992, we recommended that federal agencies issue information returns on payments to corporations providing services (GAO/GGD-92-130).
    - Federal executive agencies are now required to file information returns on payments to corporations for services provided.

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Payments to Corporations (Cont.

Compliance Costs

- Payers would face additional costs for each additional Form 1099—costs for bookkeeping, dealing with IRS, postage, and outside help maybe for the first time; payers using payment cards may have to make changes to accounting systems if the systems do not show all qualifying payments to corporations but instead show payments only to the payment card industry.

Mitigations

- Payers would face additional costs, but other costs may be reduced because the need to distinguish corporate from other payees for tax reasons could disappear.
- With adequate lead time, many payers could limit costs by using or extending current systems and procedures for paying noncorporate entities, including procedures for recording payment card payments.
- With the risk of allowing noncompliance by some payees and gaming of the system, Congress or IRS could exempt small payer businesses based on their revenues or other factors.

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Payments to Corporations (Cont.)

Compliance Costs

- Payers may have to file Forms 1099 for payments to about 6 million corporations, including S corporations, regardless of size, and some of the corporations would have many addresses.

Mitigations

- At the risk of extra complexity, Congress could require that Forms 1099 be sent to only some corporations, such as those privately held or below a certain size, for instance, smaller than the Fortune 500.
    - To reduce payers' burden of determining which corporations are exempt, exempt corporations' invoices could show the exemption.
- Congress could raise the $600 reporting floor, although compliance by current and future filers could suffer.

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Payments to Corporations (Cont.)

Compliance Costs

- Payers may have to incur the costs of reporting payments for outsourced daily operations, such as overnight mail delivery.

Mitigations

- IRS could extend existing exemptions for payments like freight, effectively exempting certain categories of corporations.

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Payments to Corporations (Cont.)

Compliance Costs

- Start-up costs would be incurred to collect TINs and to determine which corporations predominantly provide goods and which predominantly provide services.

Mitigations

- IRS could issue guidance to require that TINs and goods versus services information be provided immediately on starting a business relationship, for example, on the invoice.
- IRS could grandfather ongoing relationships or specify a lead time for collecting information on them.

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Payments to Corporations (Cont.)

Compliance Costs

- Costs may be incurred when cash versus accrual and calendar year versus fiscal year information reporting do not match taxpayers' accounting systems and business uncertainty is created.

Mitigations

- Since
  - IRS is not planning an exact match anyway but only a trigger for questions,
  - almost all entities are on the calendar year basis,
  - large percentages are on the cash basis, and
  - accrual taxpayers might be more sophisticated than others,

  IRS could let payers know that, possibly by analyzing multiple years' data, it would work from the knowledge that years can differ for tax and accounting purposes.

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Payments to Corporations (Cont.)

Compliance Costs

- Added compliance costs would be imposed if more than one party—for instance, a bank and a payer to a service provider—is required to report information covering the same merchant transactions.

Mitigations

- Inefficient reporting could be avoided if IRS provides ordering rules or unified reporting rules so that the same transactions are not covered more than once.
- Proposals other than the payment card proposal could exempt transactions involving payment cards, as an administration proposal to expand broker information reporting does; that proposal, estimated to raise about $2.0 billion over 10 years (about $2.5 billion according to the Joint Committee on Taxation), would require brokers, such as auction houses, to file information returns for certain customers showing gross proceeds from the sale of tangible personal property; however, it would exempt sales that otherwise need to be reported, for instance, under the payment card reporting proposal.

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Payments to Corporations (Cont.)

Compliance Costs

- (Previous slide continued)

Mitigations

- Proposals could cover different kinds of transactions, such as payments to corporations continuing to focus on services and the broker proposal continuing to focus on tangible goods.

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Costs and Uses of Third-Party Information Returns

IRS's Ability to Process and Use Information Returns

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IRS's Ability to Process and Use Information Returns

IRS Processing of Information Returns

- As shown on the next slide, IRS receives and handles a growing number of information returns from payers, reaching over 1.7 billion returns for tax year 2006.
- Upon receipt, IRS puts them into a format that allows IRS to attempt to match information return information with tax return information.
- According to IRS officials, IRS has the capacity to process the information returns it currently receives electronically, but large files may take a few hours to upload from the receiving server to the main systems.
  - Delays in uploading files near the March 30 deadline may occur because this is the peak time for receipts.

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IRS's Ability to Process and Use Information Returns (Cont.)

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Receipt of Information Returns (Numbers in Millions)

Type of information return	Tax year 2003	Tax year 2004	Tax year 2005	Tax year 2006
Electronic	485	685	847	1,163
Magnetic tape	583	473	368	250
Paper	47	49	56	50
Other (including wage and tax statements from the Social Security Administration)	275	280	290	299 (as of October 2007)
Total	**1,390**	**1,487**	**1,561**	**1,762**

Source: IRS Data Books for tax years 2003 through 2005 and IRS for tax year 2006.

Note: Numbers include such information returns as mortgage interest, broker proceeds, interest and dividend distributions, and individual retirement arrangements.

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IRS's Ability to Process and Use Information Returns (Cont.)

- According to IRS officials, once formatted by IRS, 97 percent of information returns received can potentially be used for matching purposes.
- Thus, about 3 percent of information returns received need a TIN supplied or corrected.
- According to IRS officials, IRS can supply or correct TINs for 35 to 40 percent of this 3 percent.
- Therefore, about 98 percent of information returns are potentially usable for matching purposes.

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IRS's Ability to Process and Use Information Returns (Cont.)

- According to IRS officials, IRS uses about 90 percent of the potentially usable information returns in its matching efforts for individual taxpayers. Discrepancies between what is reported on a taxpayer's information returns and tax return may be referred to the Automated Underreporter (AUR) program. Information returns that cannot be matched to a filed individual tax return may be referred to the nonfiler program. Of the 10 percent of information returns that cannot be used in the matching efforts for individual taxpayers, over 90 percent are associated with businesses that are not sole proprietors (businesses that do not file a Schedule C).
    - IRS may not use each line on each type of usable information return for matching purposes.
- According to IRS officials, IRS does not know the total number of discrepancies that its matching efforts discover because discrepancies under certain dollar thresholds are not tracked.
- Above these dollar thresholds, as the next slide shows, the AUR and nonfiler programs pursue millions of discrepancies; according to IRS officials, millions of other discrepancies above the thresholds are not pursued because of resource constraints.

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IRS's Ability to Process and Use Information Returns (Cont.)

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Use of Information Returns
(Numbers in Millions)

Type of cases	Tax year 2003	Tax year 2004	Tax year 2005
AUR cases (above IRS's dollar threshold)			
Identified	14.5	15.0	15.0
Pursued	4.1	4.6	4.5
Percentage pursued	28%	31%	30%
Nonfiling of tax return cases (above IRS's dollar threshold)			
Identified	7.4	7.5	7.9
Pursued	4.4	3.1	2.8
Percentage pursued	59%	41%	35%

Source: IRS.

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IRS's Ability to Process and Use Information Returns (Cont.)

Criteria Used to Select AUR Cases to Be Pursued

- Dollars by category
  - Generally, AUR pursues the higher dollar cases after categorizing the cases based on the type of income or expenses involved and the potential extra tax that might be assessed.
- Coverage
  - However, regardless of dollars, AUR usually pursues a small number of cases in most categories to maintain a presence.
- High risk
  - AUR also pursues cases in certain high-risk areas regardless of dollars and coverage (e.g., stock and bond sales and Schedule C returns).

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IRS's Ability to Process and Use Information Returns (Cont.)

Other Uses of Matching Data

- According to IRS officials, non-IRS requesters of information return data matched to tax return data use it for nontax purposes, such as determining eligibility for veterans and welfare benefits.

- Also, according to IRS officials, IRS functions such as Examination, Collection, and Criminal Investigation also use the data.

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IRS's Ability to Process and Use Information Returns (Cont.)

IRS Efforts to Find Nonreporters and Underreporters of Information Returns

- IRS has a program to contact federal government entities that do not file any required information returns.
- As part of taxpayer audits and collection compliance checks, IRS officials are required to check if required information returns are filed.

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IRS's Ability to Process and Use Information Returns (Cont.)

IRS Costs and Plans to Accommodate More Information Reporting

- In costing out its various fiscal year 2008 legislative proposals, IRS said that it assumed 100 percent electronic filing for most proposals. It added, however, that it would be reasonable to assume that about 15 to 20 percent of information returns would actually be on paper.
- For fiscal year 2008, programming and start-up costs were budgeted at $8 million for the payment card proposal and $3.8 million for the payments-to-corporations proposal; after fiscal year 2008, IRS estimated administrative implementation costs at another $12.7 million and $4.1 million, respectively. Overall for the payments-to-corporations proposal, IRS said its cost estimates could vary by an additional several million dollars.
- According to the fiscal year 2008 budget proposal, IRS expected about 125 million payment card returns annually associated with small business and self-employed taxpayers.

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IRS's Ability to Process and Use Information Returns (Cont.)

- For the payments-to-corporations proposal, IRS conservatively estimated 60 million forms arriving annually, saying the actual number could range into the billions.
- If specific legislation is enacted and IRS and Treasury are formulating regulations, IRS will be in a better position to estimate how many information returns, including those in paper form, will be arriving.
- By design, IRS estimated only the costs it did because of the uncertainty of whether legislation would pass and how it would be implemented, and it did not cost out enforcement estimates.
    - For instance, it did not cost out the hundreds of full-time equivalent staff years that it expected to be needed on an ongoing basis to use information gained from the payments-to-corporations proposal.

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IRS's Ability to Process and Use Information Returns (Cont.)

- If information reporting proposals are passed, IRS would be responsible for addressing the benefits and costs of the resulting information collections as part of its responsibilities under the Paperwork Reduction Act of 1995.
    - Under the act, agencies are responsible for ensuring that information collections are implemented to minimize the burden on the public while maximizing utility.
    - In addition, the Office of Management and Budget is responsible for reviewing and approving proposed information collections.

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