



*The Schedule K-1 Matching Program Has
Been Improved, but More Can Be Done to
Increase Its Effectiveness*

September 25, 2006

Reference Number: 2006-30-159

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 25, 2006

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Schedule K-1 Matching Program Has Been
Improved, but More Can Be Done to Increase Its Effectiveness
(Audit # 200530031)

This report presents the results of our review of the Schedule K-1¹ portion of the Underreporter Matching program. The overall objective of this review was to determine whether changes in the processing of cases involving Schedule K-1 income in the Internal Revenue Service's (IRS) Underreporter matching program have improved the program's effectiveness. We also determined whether additional steps could be taken to further reduce the issuance of unnecessary notices to individual taxpayers and still ensure notices are issued when needed.

Impact on the Taxpayer

As of March 31, 2006, the IRS had issued 71,000 notices to taxpayers questioning whether they had properly reported their income from Schedule K-1 for Tax Year 2003. Many notices could have been avoided if taxpayers and/or their preparers had ensured documentation was provided to show offsets they had taken against income related to Schedules K-1, and if they had ensured their Schedule K-1 entity information was accurate when the Schedules K-1 were originally filed. By making the changes recommended in this report, the IRS can further reduce the burden experienced by taxpayers receiving unnecessary notices questioning whether they included all of their income from Schedules K-1 on their individual income tax returns.

¹ Beneficiary's Share of Income, Deductions, Credits, etc. (Form 1041 Schedule K-1); Partner's Share of Income, Deductions, Credits, etc. (Form 1065 Schedule K-1); and Shareholder's Share of Income, Deductions, Credits, etc. (Form 1120S Schedule K-1).



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Synopsis

In two previous reports,² we discussed how the limitations on the IRS form Supplemental Income and Loss (Form 1040³ Schedule E) would result in unnecessary notices to taxpayers and recommended certain changes be made to the Schedule E to improve the effectiveness of the Schedule K-1 matching program. The IRS made changes to the Schedule E and its instructions, asking taxpayers to separately identify offset amounts and identify the reasons for the offsets. However, IRS management states they are limited in what changes they can make to the current Schedule E. In addition, issues relating to the burden caused by additional reporting requirements for taxpayers and costs related to processing any additional information have to be weighed against the costs of manually screening these cases in the Underreporter function.

The IRS has continued to implement ways to reduce the issuance of unnecessary notices, including extensive screening of the tax returns to locate reasons for differences between what was reported to the IRS on Schedules K-1 and what taxpayers reported on their individual income tax returns.⁴ The screen-out and no-change rates continue to be high for this program.

Most of the notices resulting in no change to tax could have been avoided. Based on a limited judgmental sample of 57 no-change cases, we determined the majority of unnecessary notices issued to taxpayers were due to taxpayer or preparer errors. Many of these taxpayer and preparer errors could have been avoided if proper documentation had been provided to show offsets that had been taken against income related to Schedule K-1 or if Schedule K-1 entity information had been accurate when the Schedules were originally filed.

Other unnecessary notices resulted from IRS processing errors and could have been avoided had the IRS ensured the Schedules K-1 from fiscal year tax returns⁵ were included in the correct year's Information Returns database. During discussions with IRS officials, we learned that electronically filed fiscal year Schedules K-1 were not properly identified as fiscal year returns

² *The Internal Revenue Service Successfully Processed Schedules K-1 for Its Matching Program, However, Tax Form Changes Would Reduce Unnecessary Notices to Taxpayers* (Reference Number 2002-30-141, dated July 2002) and *The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedules K-1* (Reference Number 2003-30-071, dated March 2003).

³ U.S. Individual Income Tax Return.

⁴ A case is first screened by an IRS employee, who manually reviews the taxpayer's individual income tax return to find (or match) the unreported amounts. If the amounts are located, the case is closed or "screened-out," and no action is taken. If the unreported amounts are not found on a taxpayer's return during screening, the IRS sends a notice to the taxpayer regarding the unreported income amounts. Any taxpayer receiving a notice as a result of an Underreporter program case is given an opportunity to respond to the IRS to explain how the income has been accounted for on his or her Form 1040. If a taxpayer's response adequately accounts for the income, the case is closed with no change to tax.

⁵ A fiscal year return is filed when a tax entity's annual accounting period ends in any month other than December. The allocated income from that year's activities is reported on an individual's calendar year tax return for the year in which the entity's fiscal year ends.



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when they were initially processed. The IRS is aware of this problem and has corrected the problem for electronically filed fiscal year Forms 1120S⁶ and the related Schedules K-1. Remedial steps have been taken to identify fiscal year Forms 1065 and Forms 1041⁷ and apply these returns to the correct year's Information Returns database until the problem with the initial processing of these forms is corrected.

Recommendations

We recommended the Director, Submission Processing, Wage and Investment Division, ensure electronically filed fiscal year Forms 1065 and 1041 are processed to the correct tax period. We also recommended the Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division, further communicate the importance of providing schedules to explain differences in income reported on Schedules K-1 and amounts reported on Schedule E, and stress the importance of providing properly prepared Schedules K-1.

Response

IRS management agreed with our first recommendation and substantially agreed with our second recommendation. Requirements to process fiscal year Schedules K-1 to the correct year have been included in the Processing Year 2007 Request for Information Services.⁸ The Communications, Liaison, and Disclosure function in the Small Business/Self-Employed Division agreed to develop and implement a communication strategy to reemphasize accurate reporting of income and losses on Schedules K-1 and will also reemphasize to Schedule K-1 preparers the necessity of properly identifying the entity responsible for reporting the Schedule K-1 income. They also agreed to explore the feasibility of including information on Computer Paragraph 2000 notices about these issues. The IRS does not agree that taxpayers should be instructed to provide schedules for unexplained offsets. In our opinion, the IRS' corrective actions will satisfactorily address this issue. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8500.

⁶ U.S. Income Tax Return for an S Corporation (Form 1120S).

⁷ U.S. Return of Partnership Income (Form 1065) and U.S. Income Tax Return for Estates and Trusts (Form 1041).

⁸ Requests for Information Services are formal written requests for changes to IRS computer programs.



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Abbreviations

IRS	Internal Revenue Service
TY	Tax Year
U.S.	United States



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Background

Beneficiary's Share of Income, Deductions, Credits, etc. (Form 1041¹ Schedule K-1); Partner's Share of Income, Deductions, Credits, etc. (Form 1065² Schedule K-1); and Shareholder's Share of Income, Deductions, Credits, etc. (Form 1120S³ Schedule K-1) are information returns filed by fiduciaries, partnerships, and S Corporations, respectively. They report the share of income, losses, deductions, and credits that flow through to each beneficiary, partner, or shareholder. The majority of Schedules K-1 received are associated with individual taxpayers, who should report the appropriate income amounts on their U.S. Individual Income Tax Returns (Form 1040). Beginning with Tax Year (TY) 2000, Schedules K-1 not filed electronically were entered into Internal Revenue Service (IRS) computers and combined with electronically filed Schedule K-1 information for use in the IRS Underreporter program.⁴ We reported on the Schedule K-1 processing results and the initial Schedule K-1 Underreporter matching program results in 2002 and 2003, respectively.⁵

The IRS had mixed results in matching Schedule K-1 income during the first 2 years of the matching program.⁶ Initially, only about 1 of 10 cases resulted in an assessment. Many notices unnecessarily were sent to taxpayers and resulted in no additional tax. The first year no-change rate for notices sent was approximately 55 percent. Since then, the IRS, tax preparers, and taxpayers have made improvements that have helped the effectiveness of the Schedule K-1 matching program. No-change rates for TY 2002 were 33 percent. As of March 31, 2006, the IRS had issued close to 71,000 notices to taxpayers questioning whether they had properly reported their income from Schedule K-1 for TY 2003. Current no-change rates for TY 2003 are 37 percent. To further improve the Schedule K-1 matching program's effectiveness, additional changes need to be made. By making the changes outlined in this report, the IRS can further reduce the burden experienced by taxpayers receiving unnecessary notices questioning whether they included all of their income from Schedules K-1 on their individual income tax returns.

¹ U.S. Income Tax Return for Estates and Trusts.

² U.S. Return of Partnership Income.

³ U.S. Income Tax Return for an S Corporation.

⁴ The IRS Underreporter program compares the IRS database of Information Returns filed by employers, banks, corporations, etc., to the IRS database of individual taxpayer returns.

⁵ *The Internal Revenue Service Successfully Processed Schedules K-1 for Its Matching Program, However, Tax Form Changes Would Reduce Unnecessary Notices to Taxpayers* (Reference Number 2002-30-141, dated July 2002) and *The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedules K-1* (Reference Number 2003-30-071, dated March 2003).

⁶ The Schedule K-1 matching program was initiated in 2002 and matched TY 2000 returns.



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This review was performed at the IRS Campuses⁷ in Ogden, Utah, and Philadelphia, Pennsylvania, during the period January through May 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁷ Campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Results of Review

Several Changes to Reduce the Number of Unnecessary Notices Issued Have Been Implemented

When data captured from a taxpayer's records indicates the taxpayer reported less income on his or her individual income tax return than payers reported on information returns, an Underreporter program case is generated. The case is first screened by an IRS employee, who manually reviews the taxpayer's individual income tax return to find (or match) the unreported amounts. If the amounts are located, the case is closed or "screened-out," and no action is taken. If the unreported amounts are not found on a taxpayer's return during screening, the IRS sends a notice to the taxpayer regarding the unreported income amounts. Any taxpayer receiving a notice as a result of an Underreporter program case is given an opportunity to respond to the IRS to explain how the income has been accounted for on his or her Form 1040. If a taxpayer's response adequately accounts for the income, the case is closed with no change to tax.

Schedule K-1 income is more difficult to match than the wage, interest, dividend, pension, and similar income types that are normally identified by the Underreporter program. Tax law issues, such as at-risk loss⁸ and passive-activity loss⁹ rules, and business deductions taken at the taxpayer level make matching difficult. In addition, several types of income and deductions reported on the Schedules K-1 may be found on many different schedules and attachments to a taxpayer's individual tax return.

Because of these difficulties in matching Schedule K-1 income, the Underreporter function implemented several procedures to ensure notices were not issued to taxpayers unnecessarily. Screeners are instructed to search a return thoroughly to identify typical offset issues that could result in reporting differences and special procedures are in place for items that appear to be partially reported.

In 2003, the IRS changed the Supplemental Income and Loss (Form 1040 Schedule E) and related instructions to ensure taxpayers included an explanation of any discrepancies between amounts reported to them on Schedules K-1 and amounts entered on their Form 1040 Schedule E. A check box was added to Schedule E Part II for taxpayers that are reporting a loss

⁸ The at-risk rules limit the amount of losses that can be deducted to the amount a taxpayer has at risk. These rules apply to losses from certain activities carried on as a trade or business or for the production of income.

⁹ A passive activity loss occurs when total losses from all passive activities exceed total income for all passive activities. Passive activity losses cannot be used to offset income from nonpassive activities. Passive activities include trade or business activities in which a person does not materially participate for the tax year. It also includes rental activities, regardless of the participation.



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not allowed in a prior year or deducting unreimbursed partnership expenses. The instructions ask taxpayers to explain these differences on separate lines of the Schedule E Part II and to label these amounts appropriately.

However, current statistics indicate this has done little to change the screen-out and no-change rates. As of March 31, 2006, the screen-out rate for TY 2003 Schedule K-1 cases was 72 percent. For the remaining cases that had notices issued, the no-change rate was 37 percent (with 85 percent of the notices resolved). For TY 2002 Schedule K-1 cases, the screen-out and no-change rates were 75 percent and 33 percent, respectively, with 92 percent of all notices resolved. This means only 18 and 17 percent¹⁰ of the cases initially selected for screening resulted in a tax assessment for those 2 years. The overall Underreporting matching program has an assessment rate of approximately 46 percent.

In our two earlier reviews, we recommended the IRS consider making changes to the Schedule E to facilitate computer matching of Schedule K-1 income items. We cited a July 2000 IRS study that proposed the IRS change the Schedule E to require taxpayers to separately list the original amounts reported on Schedules K-1 and show the amount by which this income is offset. However, IRS management states they are limited in what changes they can make to the current Schedule E. In addition, issues relating to the burden caused by additional reporting requirements for taxpayers and costs related to processing any additional information have to be weighed against the costs of manually screening these cases in the Underreporter function. Because of these limitations, the Schedule K-1 matching portion of the Underreporter program will continue to require extensive manual screening of these cases and, accordingly, will have significantly lower overall assessment rates for Schedule K-1 income than for other types of income.

The Accuracy of Schedule K-1 Information Has Improved, but Fiscal Year Schedules K-1 Are Not Always Properly Classified

In our 2002 report on the IRS' processing of paper Schedules K-1, we noted the error rates were quite low. We identified a 3.4 percent error rate, while 2 IRS reviews at the Ogden Campus found exception rates between 2.5 percent and 3.7 percent. However, we did note that these relatively small exception rates could still result in a significant number of underreported Schedule K-1 cases due to the trickle-down effect of the incorrect information. In our 2003 report, we confirmed many cases that resulted in unnecessary notices being sent to taxpayers involved IRS errors made during Schedule K-1 processing. At that time, 22 percent of the notices issued to taxpayers that subsequently resulted in no change to tax were caused by apparent IRS processing errors.

¹⁰ $(1-.72)*(1-.37) = .18$ and $(1-.75)*(1-.33) = .17$.



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In our current review of a limited judgmental sample of 57 notices related to Schedules K-1 that were sent to taxpayers and subsequently resulted in no changes to the taxpayers' accounts, we found 9 cases (16 percent) were caused by apparent IRS return processing errors. This is down 6 percent from the error rate identified in our prior review.

Although accuracy has improved since our prior review, the IRS still needs to properly identify fiscal year returns during Schedule K-1 processing and ensure the Schedules K-1 from fiscal year tax returns are included in the correct year's Information Returns database. Five of 11 cases in our 2003 report involved fiscal year returns¹¹ with Schedules K-1 that were misclassified as TY 2000 instead of TY 2001 information returns. Of the nine IRS processing errors we identified during this review, five were due to the IRS not identifying fiscal year Schedules K-1.¹² These returns were included in the TY 2003 rather than the TY 2004 Information Returns database.

Discussions with IRS officials indicated that electronically filed fiscal year Schedules K-1 are not properly identified as fiscal year returns when they are initially processed. The IRS is aware of this problem and they have corrected the problem for electronically filed fiscal year Forms 1120S and the related Schedules K-1. They have been taking remedial steps to identify fiscal year Forms 1065 and Forms 1041 and apply these returns to the correct year's Information Returns database until the problem with the initial processing of these forms is corrected.

Recommendation

Recommendation 1: The Director, Submission Processing, Wage and Investment Division, should ensure electronically filed fiscal year Forms 1065 and Forms 1041 are processed to the correct tax period during initial processing. This would help ensure the correct amount of income will be identified for the Schedule K-1 matching program in the proper year and should reduce the issuance of unnecessary notices for those years when the income is improperly classified by the IRS.

Management's Response: The Director, Wage and Investment Division, Customer Account Services, Submission Processing, has included requirements to process fiscal year Schedules K-1 to the correct year in the Processing Year 2007 Request for Information Services.¹³

¹¹ A fiscal year return is filed when a tax entity's annual accounting period ends in any month other than December. The allocated income from that year's activities is reported on an individual's calendar year tax return for the year in which the entity's fiscal year ends.

¹² No specific trends were identified in the other cases.

¹³ Requests for Information Services are formal written requests for changes to IRS computer programs.



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Cases Were Closed With No Change to Tax Primarily Because of Taxpayer Errors or Omissions

Many notices issued to taxpayers and subsequently closed with no change to tax could have been avoided if taxpayers and/or their preparers had ensured documentation was provided to show offsets they had taken against income related to Schedules K-1 and if they had ensured their Schedule K-1 entity information was accurate when the Schedules K-1 were originally filed.

In our sample of 57 TY 2003 no-change cases, almost 2 of every 3 notices (39/57 or 68 percent) were issued because of a taxpayer or preparer error. Taxpayers had omitted schedules or documentation explaining offsets or other adjustments to their Schedule K-1 income in 16 of the 57 cases (28 percent).¹⁴ Another 16 cases were due to inaccurate information regarding the person responsible for reporting the Schedule K-1 income.¹⁵ Examples of these errors included income reported on the wrong types of tax returns or by the wrong individuals or business entities.

Recommendation

Recommendation 2: The Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division, should issue additional instructions and alerts to taxpayers and preparers stressing the need to provide schedules to explain any offsets to income reported on Schedules K-1 when it is entered on individual Schedules E. Communications to preparers should also stress the need to ensure entity information on Schedules K-1 properly identifies the taxpayer (or other entity) responsible for reporting the Schedule K-1 income. The Computer Paragraph 2000 issued for Schedules K-1 mismatches may be an appropriate vehicle through which to provide this information. The Director should work with the Director, Reporting Compliance, Wage and Investment Division, to explore this option.

Management's Response: Management substantially agreed with our recommendation. The Communications, Liaison, and Disclosure function in the Small Business/Self-Employed Division agreed to develop and implement a communication strategy to reemphasize accurate reporting of income and losses on Schedules K-1 and will also reemphasize to Schedule K-1 preparers the necessity of properly identifying the entity responsible for reporting the Schedule K-1 income. They also agreed to explore

¹⁴ In our 2003 report, we noted 60 percent of the no-change cases were the result of taxpayers not identifying the reasons for differences between income reported on their Schedules K-1 and amounts shown on their Schedules E.

¹⁵ No specific trends were identified in the other seven cases.



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the feasibility of including information on Computer Paragraph 2000 notices about these issues. The IRS does not agree that taxpayers should be instructed to provide schedules for unexplained offsets.

Office of Audit Comment: In our opinion, the IRS' corrective actions will satisfactorily address this issue.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether changes in the processing of cases involving Schedule K-1¹ income in the IRS Underreporter matching program have improved the program's effectiveness. We also determined whether additional steps could be taken to further reduce the issuance of unnecessary notices to individual taxpayers and still ensure notices are issued when needed. Specifically, we:

- I. Determined the changes in forms and instructions and in processing guidelines that have been implemented since our last review and evaluated the effectiveness of any planned changes.
 - A. Reviewed changes made to the U.S. Individual Income Tax Return (Form 1040) Supplemental Income and Loss (Schedule E) and the related instructions.
 - B. Identified any changes to the Underreporter program instructions for cases with Schedules K-1.
 - C. Discussed recent changes and any planned changes to the Schedule E with responsible employees from the IRS Tax Forms and Publications office.
 - D. Discussed the results of the cross-functional task force that evaluated ways to simplify and make Schedules K-1 and E easier to match and less burdensome for taxpayers with responsible employees from the Taxpayer Burden Reduction and Compliance Strategies office.
 - E. Evaluated the effectiveness of implemented changes and the likely improvements that planned changes will provide.
- II. Determined whether the IRS has reduced the number of unnecessary notices related to Schedules K-1 issued to taxpayers.
 - A. Obtained and analyzed statistics for Underreporter cases related to Schedules K-1 for TYs 2000 through 2003.²

¹ Beneficiary's Share of Income, Deductions, Credits, etc. (Form 1041 Schedule K-1); Partner's Share of Income, Deductions, Credits, etc. (Form 1065 Schedule K-1); and Shareholder's Share of Income, Deductions, Credits, etc. (Form 1120S Schedule K-1). Form 1041 is a U.S. Income Tax Return for Estates and Trusts. Form 1065 is a U.S. Return of Partnership Income. Form 1120S is a U.S. Income Tax Return for an S Corporation.

² We did not test the statistics provided by the IRS. However, they were consistent from year to year and did not have any apparent anomalies.



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- B. Discussed the significance of statistics as they relate to processing and form changes with responsible Underreporter program analysts.
- III. Determined whether changes to Schedules K-1 and E and instructions improved the accuracy and effectiveness of Schedule K-1 matching program case processing.
- A. Selected a judgmental sample of 80 “screened-out” cases³ to determine the cause for the initial case and whether taxpayers provided information to show why reporting differences occurred. A judgmental sample was required because the entire universe of cases was not available for our review. We selected cases as they were closed by tax examiners and determined whether the cases were the result of:
- IRS input errors.
 - IRS Underreporter program errors.
 - Forms 1041, 1065, or 1120S reporting problems, such as amended returns or misclassified or misreported amounts.
 - Taxpayer reporting issues, such as offsets or netting.
- B. Selected a judgmental sample of 57 TY 2003 “no-change” cases to determine the cause for the initial case, potential ways to prevent the case, and whether the case should have been screened out without the issuance of a notice. A judgmental sample was required because the entire universe of cases was not available for our review. We selected cases as they were closed by tax examiners and determined whether the cases were the result of:
- IRS input errors.
 - IRS Underreporter program errors.
 - Forms 1041, 1065, or 1120S reporting problems, such as amended returns or misclassified or misreported amounts.
 - Taxpayer reporting issues, such as offsets or netting.

³ A case is first screened by an IRS employee, who manually reviews the taxpayer’s individual income tax return to find (or match) the unreported amounts. If the amounts are located, the case is closed or “screened-out,” and no action is taken. If the unreported amounts are not found on a taxpayer’s return during screening, the IRS sends a notice to the taxpayer regarding the unreported income amounts. Any taxpayer receiving a notice as a result of an Underreporter program case is given an opportunity to respond to the IRS to explain how the income has been accounted for on his or her Form 1040. If a taxpayer’s response adequately accounts for the income, the case is closed with no change to tax.



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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Kyle R. Andersen, Director

Larry Madsen, Audit Manager

Greg Schmidt, Lead Auditor

Kyle D. Bambrough, Senior Auditor



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Appendix III

Report Distribution List

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Deputy Commissioner, Wage and Investment Division SE:W
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Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
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Appendix IV

Management's Response to the Draft Report

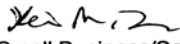


COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
SEP 19 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Schedule K-1 Matching Program Has
Been Improved, but More Can Be Done to Increase Its
Effectiveness (Audit # 200530031)

We have reviewed your report and appreciate your acknowledgement of the improvements we have made to the Schedule K-1 matching program. Through a number of efforts, we have worked since late 2002 to increase the efficiency and effectiveness of the program.

We have increased training, implemented additional filters during screening, redesigned multiple forms and instructions, and executed an extensive outreach and education program to help taxpayers and tax professionals avoid errors related to reporting income from Schedules K-1.

We agree with your recommendation to ensure proper processing of electronically filed fiscal year Forms 1065, U.S. Partnership Return of Income, and Forms 1041, U.S. Income Tax Return for Estates and Trusts, and are taking corrective action.

Although we do not agree with your recommendation to advise taxpayers to provide schedules explaining offsets to income on Schedules K-1 when entering the amount on individual Schedules E, Supplemental Income, SB/SE Communications, Liaison, and Disclosure (CLD) will develop and implement a communications strategy to reemphasize accurate reporting of income and losses on Schedules K-1. One of the primary actions we have taken to improve the matching program has been to emphasize through outreach and in our instructions the requirement to enter gross amounts from Schedules K-1 on Schedule E and to avoid netting or combining income against losses or expenses. As stated in our instructions, news releases, and other external guidance, unreimbursed partnership expenses are entered on a separate line in column (h) of line 28. Losses from passive activities are reported on Form 8582 and its worksheets. No other offsets are appropriate even if explained on a separate schedule.



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2

Attached is a detailed response outlining our planned corrective actions. If you have any questions, please call me at (202) 622-0600 or Beth Tucker, Director, SB/SE, Communications, Liaison and Disclosure at (972) 308-1676.

Attachment



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Attachment

RECOMMENDATION 1

The Director, Submission Processing, Wage and Investment Division, should ensure electronically filed fiscal year Forms 1065 and Forms 1041 are processed to the correct tax period during initial processing. This would help ensure the correct amount of income will be identified for the Schedule K-1 matching program in the proper year and should reduce the issuance of unnecessary notices for those years when the income is improperly classified by the IRS.

CORRECTIVE ACTION

Requirements to process fiscal year Forms K-1 in the correct year have been included in Processing Year 2007 Request for Information Services (RISs).

IMPLEMENTATION DATE

January 15, 2007

RESPONSIBLE OFFICIAL

Director, W&I, Customer Account Services, Submission Processing

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of W&I's internal management control system.

RECOMMENDATION 2

The Director, Communications, Liaison, and Disclosure, SB/SE Division, should issue additional instructions and alerts to taxpayers and preparers stressing the need to provide schedules to explain any offsets to income reported on Schedules K-1 when it is entered on individual Schedules E. Communications to preparers should also stress the need to ensure entity information on Schedules K-1 properly identifies the taxpayer (or other entity) responsible for reporting the Schedule K-1 income. The Computer Paragraph 2000 issued for Schedules K-1 mismatches may be an appropriate vehicle through which to provide this information. The Director should work with the Director, Reporting Compliance, Wage and Investment Division to explore this option.

CORRECTIVE ACTION

SB/SE Communications, Liaison, and Disclosure (CLD) will develop and implement a communications strategy to reemphasize accurate reporting of income and losses on Schedules K-1. The educational materials will stress that unreimbursed partnership expenses are entered on a separate line in column (h) of line 28. Losses from passive activities are reported on Form 8582 and its worksheets. No other offsets are appropriate. CLD will also reemphasize to Schedule K-1 preparers the necessity of properly identifying the entity responsible for reporting the Schedule K-1 income and will explore the feasibility of including information on CP-2000 notices about these issues.



*The Schedule K-1 Matching Program Has Been Improved, but
More Can Be Done to Increase Its Effectiveness*

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IMPLEMENTATION DATE

April 30, 2007

RESPONSIBLE OFFICIAL

Director, SB/SE, Communication, Liaison and Disclosure

CORRECTIVE ACTION MONITORING PLAN

The Director, CLD, SB/SE Division, will advise the SB/SE Commissioner of any delays in implementing this corrective action.