

**Opportunities Exist to Identify Unreported
Taxes from Employer's Quarterly Federal Tax
Returns**

September 2000

Reference Number: 2000-30-146

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 15, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Opportunities Exist to Identify Unreported
Taxes from Employer's Quarterly Federal Tax Returns

This report presents the results of our review of the Internal Revenue Service's (IRS) Employer's Quarterly Federal Tax Returns (Form 941) compliance efforts. We found that the IRS can increase compliance efforts and identify potential unreported taxes from Forms 941 by using data received from the Social Security Administration (SSA) and from the Forms 941 themselves. By using the IRS' data, we identified 491 employers that potentially reported \$5.4 billion less in wages to the IRS on their Forms 941 than they did to the SSA on Wage and Tax Statements (Form W-2) in Tax Year 1998. We believe there is a unique opportunity under the new Small Business/Self-Employed Division and the Large and Mid-Size Business Division for the IRS to focus its compliance efforts to ensure accurate reporting of employment tax information on Forms 941.

Management's response was due on September 11, 2000. As of September 12, 2000, management had not responded to this draft report.

Copies of this report are being sent to IRS managers who are affected by the reports recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**Opportunities Exist to Identify Unreported Taxes from
Employer’s Quarterly Federal Tax Returns**

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Opportunities Exist to Identify Unreported Taxes from Employer's Quarterly Federal Tax Returns

Executive Summary

There are significant unresolved differences between the tax information employers reported to the Internal Revenue Service (IRS) and the information they reported to the Social Security Administration (SSA). These discrepancies bring in to question the accuracy of many Employer's Quarterly Federal Tax Returns (Form 941), including taxes employers are reporting and paying to the IRS as well as refunds they are receiving.

Employers file Forms 941 with the IRS when they pay wages subject to income tax withholding, social security, and Medicare taxes. There were approximately 23 million Forms 941 filed in Tax Year (TY) 1998. Of these Forms 941, nearly 1.5 million resulted in refunds totaling approximately \$1.5 billion. The payment of employment taxes accounts for over \$500 billion of the federal budget and is a large part of our voluntary tax system.

We conducted this audit to identify ways the IRS can improve its compliance efforts to help ensure accurate reporting of employment tax information on Forms 941.

Results

The IRS can increase compliance efforts and identify potential unreported taxes from Forms 941 by using data received from the SSA and from the Forms 941 themselves. We believe that there is a unique opportunity under the new Small Business/Self-Employed Division and Large and Mid-Size Business Division for the IRS to focus its compliance efforts to ensure accurate reporting of employment tax information on Forms 941.

The Internal Revenue Service Can Identify Potential Unreported Taxes by Using Available Data

The IRS can use data it receives from the SSA and from Forms 941 to identify potential unreported taxes in the following two areas.

- Employers may have underreported income, social security, and Medicare taxes on Forms 941. By using the IRS' data, we identified 491 employers that potentially reported \$5.4 billion less in wages to the IRS on their Forms 941 than they reported to the SSA on Forms W-2 for TY 1998.
- Employers potentially reported more advanced Earned Income Credit (EIC) on their Forms 941 than they paid to their employees. The amount of advanced EIC reported on Forms 941 nationwide was \$170 million for TY 1998, but the amount individual taxpayers reported on their income tax returns was only \$97 million.

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The 491 employers we identified potentially claimed nearly \$300,000 more in advanced EIC on Forms 941 than on Forms W-2. Employers can deduct a dollar-for-dollar credit against their Form 941 taxes for advanced EIC payments made to their employees. While only 1 percent of employers claimed advanced EIC on their Forms 941, these employers received 19 percent of the Form 941 refund dollars issued by the IRS.

The IRS has not focused its efforts to ensure the accurate reporting of employment tax information on Forms 941. Some examples include:

- Due to insufficient funding, the IRS' Combined Annual Wage Reporting (CAWR) program has not addressed 683,000 "IRS Revenue Producing Cases" in Fiscal Year 1999. Those cases are similar to those we identified.
- The Examination function performs few Form 941 audits. The latest statistics available indicate that the Examination function audits less than one half of one percent of all Forms 941.
- Criminal Investigation (CI) investigates potential tax fraud, but until this year had not captured the necessary data to identify Form 941 refund fraud. Recently, CI proposed expanding its involvement in employer-based refund fraud schemes. It has also indicated that much of its resources have been dedicated to individual taxpayer fraud.

Limited compliance efforts combined with the results of our tests indicate there is a high risk of unreported employment taxes and erroneous refunds.

Summary of Recommendation

We recommend that the Commissioners of the Small Business/Self-Employed Division and the Large and Mid-Size Business Division, and the Chief, Criminal Investigation, increase Form 941 compliance efforts. We believe that under the new IRS Business Divisions, the CAWR program and the Examination function can work together to ensure that employment tax information is accurately reported on Forms 941. The CI should follow through with its plan to expand its involvement in employer-based refund fraud schemes.

The IRS should initially focus on the 491 employers identified in our review that received refunds on TY 1998 Forms 941. These taxpayers potentially reported significantly less wages and more advanced EIC on their Forms 941 than they reported on their Forms W-2. If these efforts identify significant noncompliance, additional compliance efforts could include reviewing all taxpayers that report significantly less wages on their Forms 941 than they report on Forms W-2.

Management's Response: Management's response was due on September 11, 2000. As of September 12, 2000, management had not responded to this draft report.

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Objective and Scope

We conducted this audit to identify ways the IRS can improve its compliance efforts to help ensure accurate reporting of employment tax information on Forms 941.

We conducted this audit to identify ways the Internal Revenue Service (IRS) can improve its compliance efforts to help ensure accurate reporting of employment tax information on the Employer's Quarterly Federal Tax Return (Form 941).

We conducted this audit at the Brookhaven IRS Center and at the National Office from November 1999 to June 2000. We analyzed nationwide Form 941 data for Tax Year (TY) 1998 and supporting information. This audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The funding of government programs relies heavily on the payment of employment taxes.

The payment of employment taxes, including income, social security and Medicare taxes, provides a substantial portion of the government's budget and is a key component of the voluntary tax system.

Employment tax returns are the third largest return category processed by the IRS. Employment tax returns include Employer's Annual Federal Unemployment Tax Return (Form 940) and Form 941. The Form 941 series represents the largest number of returns filed in the employment tax category. There are 23.1 million returns in this series expected to be filed in calendar year 2001.

Employers that withhold income, social security, and Medicare taxes are required to file Forms 941 with the IRS. They are also required to file Wage and Tax Statements (Form W-2) for each employee with the Social Security Administration (SSA). Forms W-2 contain the annual wage and withholding information

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for each employee. This is the same tax information that is summarized quarterly on the Form 941. Ideally, all the information filed on Forms 941 should match the information filed on Forms W-2 for a given year. Finally, these employers must file Transmittal of Wage and Tax Statements (Form W-3) with the SSA. The Form W-3 summarizes all Forms W-2.

The Form 941 has entries for all of the employment taxes, as well as wages, tips and advanced Earned Income Credit (EIC). The advanced EIC is a dollar-for-dollar credit against taxes owed. There were 81,758 employers that claimed \$170 million in advanced EIC on their Forms 941 in 1998. The EIC has been a source of known fraud on individuals' tax returns.

The IRS' Business Masterfile (BMF)¹ shows that in Tax Year 1998, approximately 6.5 million employers filed about 23 million² Forms 941. Of these, about 1.1 million employers received refunds, totaling \$1.5 billion.

Results

Significant unresolved differences in information that employers are reporting to the IRS and the SSA can be indicators of Form 941 inaccuracies.

There are significant unresolved differences between the tax information employers reported to the IRS and the information they reported to the SSA. These discrepancies bring into question the accuracy of many Forms 941 in terms of both the taxes employers are reporting and paying to the IRS, and refunds they are receiving.

¹ The BMF is an IRS database that consists of federal tax-related transactions and accounts for employers, which includes employment taxes.

² The number of returns is based on a computer file we used from the BMF that contained 22,897,290 Forms 941 filed in TY 1998. The IRS Databook (an IRS publication that contains IRS-generated statistics) indicated there were 23,098,500 Forms 941 filed in TY 1998, a difference of less than 1 percent. Although we believe this does not have any material effect on our finding, due professional care dictates its disclosure.

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The IRS can use data it receives from the SSA and from the Forms 941 themselves to identify potential unreported taxes on Forms 941. We believe that there is a unique opportunity under the new Small Business/Self-Employed Division and the Large and Mid-Size Business Division for the IRS to focus its compliance efforts to ensure accurate reporting of employment tax information on Forms 941.

The Internal Revenue Service Can Identify Potential Unreported Taxes by Using Available Data

By using data the IRS receives from employers and the SSA, we identified significant unresolved differences between information reported to the IRS on Forms 941 and information reported on Forms W-2 to the SSA. These discrepancies involved the amount of wages and advanced EIC reported. The IRS' compliance programs are designed to review Form 941 discrepancies. However, in recent years, the IRS has not focused its efforts to ensure the accurate reporting of employment tax information on Forms 941.

Employers may have significantly underreported income, social security, and Medicare taxes on Forms 941

Unresolved discrepancies in wage information for the 491 employers we identified could represent unreported income, social security, and Medicare taxes.

By using the BMF data, we identified 491 employers,³ out of 31,978 that claimed advanced EIC and received a refund, that potentially reported a total of \$5.4 billion less in wages on their Forms 941 than they reported on their Forms W-2 in TY 1998. These unresolved discrepancies in wage information could represent unreported income, social security, and Medicare taxes.

³ The 491 employers had a potential wage discrepancy of at least \$10,000 each. There were other employers that also had wage discrepancies of less than \$10,000.

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The amount of wages and taxes on the Forms 941 should match the amounts reported on Forms W-2 for a given year. However:

- When the wages reported on the Forms 941 are greater than the wages reported on Forms W-2, this could indicate that the employers did not file all Forms W-2.
- When the wages reported on Forms 941 are less than the wages reported on Forms W-2, employers may have filed duplicate Forms W-2 with the SSA. We examined this possibility, and for the 491 employers we identified and accounted for any duplicate Forms W-2 within the \$5.4 billion wage discrepancy.

In addition, when employers do not report their employees' wages, they not only may receive a larger refund, but they also may not be reporting or paying income, social security, and Medicare taxes.

At a time when the solvency of the Social Security Trust Fund is a concern, it is possible that in addition to many employers not paying employment taxes,⁴ many other employers may be filing but not reporting the proper amount of social security taxes they owe. Also, at a time when the government is trying to expand Medicare benefits, it is important that all Medicare taxes are paid.

The IRS' compliance objectives include collecting the proper amount of tax at the least cost. Taxpayers expect the IRS to promote voluntary compliance by ensuring all taxpayers promptly pay their fair share. Employers who do not pay their fair share of trust fund taxes can have a significant impact on several government programs.

The IRS' compliance objectives include collecting the proper amount of tax at the least cost.

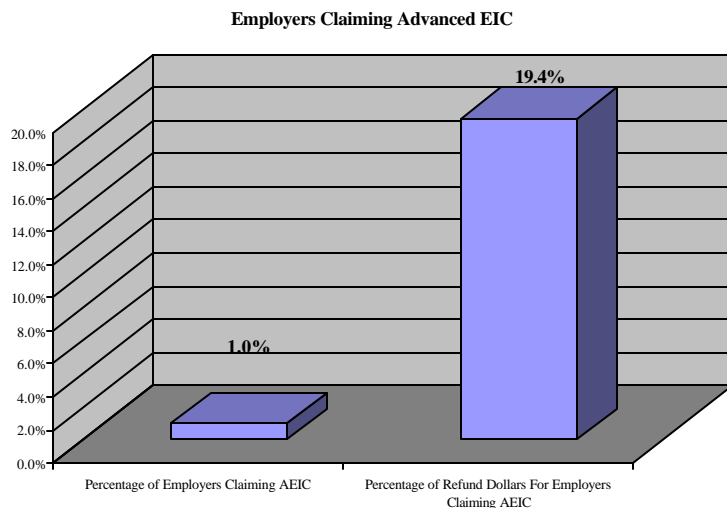
⁴ *Unpaid Payroll Taxes-Billions in Delinquent Taxes and Penalty Assessments Are Owed* (GAO Report GGD-99-211, dated August 1999).

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Employers potentially reported more advanced EIC on their Forms 941 than they paid to their employees

The total amount of advanced EIC claimed by all employers on Forms 941 in TY 1998 was \$170 million, while individuals reported only \$97 million on their Individual Income Tax Returns (Form 1040). This discrepancy could indicate that either individual taxpayers did not properly report advanced EIC on their Forms 1040 or employers overstated advanced EIC on their Forms 941. The 491 employers we identified potentially claimed nearly \$300,000 more in advanced EIC on Forms 941 than on Forms W-2.

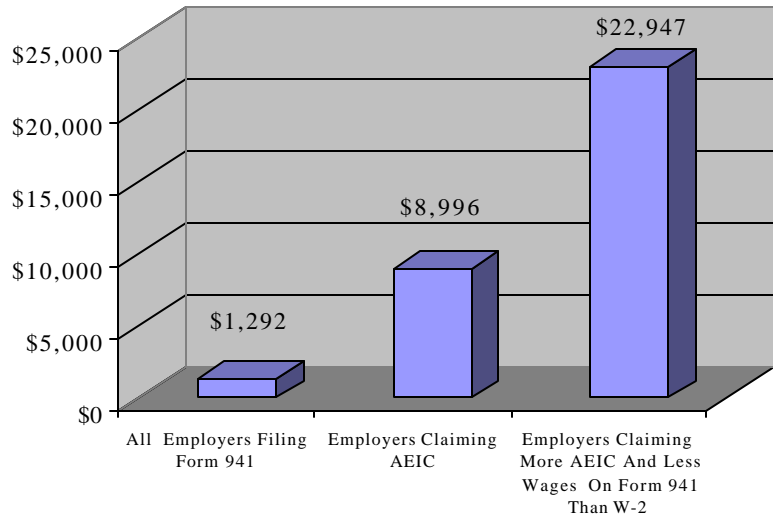
Our further examination of this discrepancy showed that only 1 percent (81,758) of all employers that filed Forms 941 claimed advanced EIC on their TY 1998 Forms 941. The following graph shows that these employers received 19 percent (\$288 million) of the Form 941 refund dollars the IRS issued. Of the 81,758 that claimed advanced EIC, 31,978 received a large portion of the total Form 941 refund dollars issued.



In addition, the following graph illustrates a correlation between employers having discrepancies in wages and advanced EIC reported on Forms 941 and Forms W-2 and the refund amount received by these employers.

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Average Refunds



This graph demonstrates:

- Employers that claimed advanced EIC on Forms 941 received a refund (\$8,996) seven times the average (\$1,292).
- Employers that claimed more advanced EIC and lower wages on their Forms 941 than on Forms W-2 received a refund (\$22,947) 18 times the average.⁵

The IRS did not focus efforts to ensure the accurate reporting of employment tax information on Forms 941

The IRS needs to increase its focus on the accuracy of employment tax information on Forms 941.

The Combined Annual Wage Reporting (CAWR) program compares employer data reported to the SSA on Forms W-2 with data reported to the IRS on Forms 941. Due to insufficient funding, IRS officials informed us that the CAWR program did not address 683,000 cases in 1999 that were similar to those we identified. These cases are known as “IRS Revenue Producing Cases.”

⁵ The Form 941 refunds are annualized. They represent all four quarters of Form 941 filings.

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In addition, the Examination function performed audits of approximately 51,000 employment tax forms, including both Forms 940 and Forms 941, in 1997. The latest statistics available indicate that the Examination function audits less than one half of one percent of all Forms 941. The audits resulted in an average assessment of \$16,000 per return, totaling nearly \$1 billion in additional tax assessed. The amount of tax assessed demonstrates that discrepancies exist and are discovered when the forms are examined.

Finally, Criminal Investigation (CI) investigates potential tax fraud, but until this year had not captured the necessary data to identify Form 941 refund fraud. It has just begun capturing the data that would be required to identify Form 941 fraud. In our discussions with CI management, they indicated that some of the forms are suspicious, but there does not appear to be a formal program being developed to review the suspicious forms. They have also indicated that much of their resources have been dedicated to individual taxpayer fraud.

In 1998, an office of the CI, in combination with the CAWR program, performed a study of some Forms 941 with advanced EIC entries. Although they were only able to complete work on 114 of the cases, they found that in 8 percent of the cases, advanced EIC was over claimed on Forms 941.

The CI has not focused on Form 941 fraud, but it plans to do so.

In a "Modernization Design Team" document dated October 29, 1999, CI proposed expanding its involvement in employer refund fraud schemes.

Recommendation

1. We recommend that the Commissioners of the Small Business/Self-Employed Division and the Large and Mid-Size Business Division, and the Chief, Criminal Investigation, increase Form 941 compliance efforts. We believe that under the new IRS Business Divisions, the CAWR program and the Examination function can work together to ensure that Forms 941

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accurately report employment tax information. The CI should follow through with its plan to expand its involvement in employer refund fraud schemes.

The IRS should initially focus on the 491 employers identified in our review that received refunds from TY 1998 Forms 941. These taxpayers potentially reported significantly less wages and more advanced EIC on their Forms 941 than they reported on Forms W-2. If these efforts identify significant noncompliance, additional compliance efforts could include reviewing all taxpayers that report significantly less wages on their Forms 941 than they report on Forms W-2.

Management's Response: Management's response was due on September 11, 2000. As of September 12, 2000, management had not responded to this draft report.

Conclusion

The payment of employment taxes accounts for over \$500 billion of the federal budget and is a large part of our voluntary tax system. Our analysis of a small number of employers showed potentially over \$5 billion in unresolved differences between the tax information employers reported to the IRS and the information reported to the SSA. The IRS can increase its compliance efforts by using the data it receives from the SSA and from Forms 941 to identify potentially significant unreported taxes from Forms 941.

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Appendix I

Detailed Objective, Scope, and Methodology

We conducted this audit to identify ways the Internal Revenue Service (IRS) can improve its compliance efforts to help ensure accurate reporting of employment tax information on the Employer's Quarterly Federal Tax Return (Form 941). Specifically, we determined whether the IRS verified the entries on Forms 941 and ensured that refunds were proper and accurate.

To accomplish this objective, we:

- I. Determined what controls were in place to validate entries on Forms 941 during processing. We randomly selected 50 Forms 941 with refunds in 2 IRS centers to determine if any were erroneous. We:
 - A. Determined which entries on Forms 941 were transcribed and whether they were transcribed accurately.
 - B. Determined if there were controls in place to verify any of the transcribed entries.
 - C. Determined if the Form 941 account information was accurate including the payments and the tax liability.
- II. We utilized a computer application for the advanced Earned Income Credit (EIC) portion of the audit. This application captured all Forms 941 filed in Tax Year 1998 (22,897,290). The Forms 941 with advanced EIC and a refund to the employers were extracted (31,978). The employers' Employer Identification Number (EIN)¹ was used to identify from the Form W-2 file which individuals had worked for the company. Then the advanced EIC and wages from Forms 941 were compared to the wages and advanced EIC on the Wage and Tax Statement (Form W-2). We evaluated the results of this computer application on advanced EIC to determine:
 - A. The reasons for any discrepancies identified.
 - B. If there was the potential for erroneous or fraudulent refunds.

¹ EIN - A unique nine-digit number used to identify a taxpayer's business account.

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- III. Reviewed the work performed by the Erroneous Refund Unit to determine what steps were taken to stop erroneous or fraudulent Form 941 refunds.
 - A. Interviewed national and local Erroneous Refund Unit personnel to determine what actions were taken to stop erroneous Form 941 refunds. Gathered information concerning the causes of erroneous or fraudulent refunds to determine if there were any trends.
 - B. Reviewed the total number of cases in their inventory (49) that pertained to Form 941 refunds and determined if refunds were repaid by employers.
- IV. Reviewed the Criminal Investigation 's (CI) involvement in identifying fraudulent Form 941 refunds by interviewing national and local CI personnel to determine what work they performed to verify Form 941 entries and identify erroneous Form 941 refunds.

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Appendix II

Major Contributors to This Report

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Appendix III

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