

**Additional Work Is Needed to Determine the
Extent of Employment Tax Underreporting**

August 2005

Reference Number: 2005-30-126

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 17, 2005

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Handwritten signature of Pamela J. Gardiner in cursive.

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Work Is Needed to Determine the
Extent of Employment Tax Underreporting (Audit # 200530006)

This report presents the results of our review to evaluate whether the Internal Revenue Service (IRS) has an effective strategy to measure employment tax reporting compliance. Employment tax is paid to the Department of the Treasury from two primary sources, as payroll tax and as self-employment tax. Payroll taxes are primarily reported on the Employer's Quarterly Federal Tax Return (Form 941); self-employment tax is reported on the Self-Employment Tax (Schedule SE) attached to a U.S. Individual Income Tax Return (Form 1040).

In summary, the Small Business/Self-Employed (SB/SE) Division has developed an extensive Employment Tax Strategy that addresses many facets of employment tax compliance. The SB/SE Division's seven pronged approach includes Tip Income, Non-Filers, Workload Identification, Collection, Legislative Initiatives and Education, and Reporting Compliance.¹ The SB/SE Division's Strategy has placed emphasis on compliance by non-filers, who the SB/SE Division considers particularly egregious. However, the reporting compliance portion of the Strategy, while considering certain components, does not primarily focus on the reporting compliance of taxpayers that file Forms 941, which represent a significant portion of Federal revenues. Several items reported on Forms 941, such as wages, other compensation, and income tax withheld, are not addressed.

¹ Reporting compliance can be measured by comparing the tax reported by a taxpayer as opposed to what should be reported.

The IRS has recognized that underreporters account for the largest portion of the tax gap.² The IRS has addressed employment tax underreporting by self-employed taxpayers who file Forms 1040 with a Profit or Loss from Business (Schedule C) during its National Research Program (NRP).³ As a result of the NRP, the IRS now estimates taxpayers with self-employment income underreport between \$51 and \$56 billion in employment tax.

Although the estimate is significant, revenue receipts from self-employed taxpayers represent a relatively small portion of employment tax revenue. Self-employed taxpayers reported \$41 billion dollars in self-employment tax in Fiscal Year 2004, while more significantly, employers that filed Forms 941 for the same period reported over \$664 billion in Social Security and Medicare tax. The amount increases to \$1.4 trillion when the amount of Federal income tax withheld from employees is included.⁴ The tax gap estimate of \$15 billion for employment taxes, which includes Forms 941, is from old data. Approximately two-thirds of the Federal Government's revenue receipts are reported on Forms 941, yet the IRS has not evaluated the extent of tax underreporting on these forms for at least 15 years.

The IRS currently has data that suggest the Forms 941 are not accurate. The IRS' Combined Annual Wage Reporting (CAWR) program has data for all Forms 941 and all of the Wage and Tax Statements (Forms W-2) that have been filed. The IRS stated there are 720,612 Forms 941 nationwide that do not balance with the Forms W-2 data for Tax Year 2003. These inaccuracies could represent unpaid tax.

The IRS has been concerned about the tax gap and is currently increasing compliance resources to address the problem. In addition, the IRS acknowledges its estimate of the \$66 billion to \$71 billion tax gap for employment taxes, from both self-employed taxpayers and those filing employment tax forms, is not accurate. This is because the tax gap data for taxpayers that file Forms 941, which reports the largest portion of employment tax revenues, is from outdated data.

We recommended the Commissioner, SB/SE Division, develop methodologies within the Employment Tax Strategy designed to evaluate the extent of underreporting by employers. Consideration should be given to incorporating the Form 941 in its NRP through the examination process, or consider using the CAWR program to evaluate the accuracy of employment tax data reported on Form 941.

Management's Response: The Commissioner, SB/SE Division, agreed with our findings and is planning, as a component of the overall Employment Tax Strategy, to develop methodologies to evaluate the extent of employment tax underreporting.

Specifically, the SB/SE Division will work with the Office of Research, Analysis, and Statistics of Income (RAS) to analyze the results of the employment tax questions included in NRP Phase I; discuss with RAS the inclusion of appropriate questions

² The tax gap includes nonfilers, underreporters of tax, and underpayers of tax.

³ The NRP was designed to measure individual taxpayer reporting compliance for Tax Year 2001.

⁴ Internal Revenue Service 2004 Data Book, Publication 55B.

regarding Form 941 in the next NRP study; and use the CAWR program as a source of employment tax examinations and incorporate the results of these examinations into their measures of reporting compliance. 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 recommendation. Please contact me at (202) 622-6510 if you have questions or Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Additional Work Is Needed to Determine the Extent of Employment Tax Underreporting

Background

Employment tax is paid to the Department of the Treasury from two primary sources, as payroll tax and as self-employment tax. Employers are required by law to withhold employment taxes from wages paid to their employees. Employment tax includes Federal income tax withholding and Social Security and Medicare taxes. Self-employed persons must pay self-employment tax on their net earnings from self-employment each year.

The following is a list of forms used to file employment taxes, known as the Form 94X series:

Form 941, Employer's Quarterly Federal Tax Return, is used to report Social Security and Medicare taxes as well as income tax withheld from wages, tips, sick pay, other compensation, and any advanced earned income credit. This is a quarterly return due the last day of the month following the end of the quarter. This form can be filed as a paper, electronic, magnetic tape, or telefile return.

Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, is used to report employers' share of unemployment contributions based on wages paid to employees. This is an annual return due on or before the last day of the month following the end of the calendar year.

Form 943, Employer's Annual Tax Return for Agricultural Employees, is used to report wages paid to farm workers. This is an annual return due on or before the last day of the month following the end of the calendar year.

Form 945, Annual Return of Withheld Federal Income Tax, is used to report income tax withholding from non-payroll distributions or payments. This is an annual return due on or before the last day of the month following the end of the calendar year.

Form CT-1, Employer's Annual Railroad Retirement Tax Return, is used to report employment taxes on wages paid to railroad employees. This is an annual return due on or before the last day of February following the end of the calendar year.

Schedule SE, which is not part of the Form 94X series, is used to report self-employment tax on net earnings from self-employment from a farm or non-farm business. It is

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filed with the U.S. Individual Income Tax Return (Form 1040).

Social Security and Medicare taxes pay for benefits that workers and their families receive under the Federal Insurance Contributions Act (FICA).¹ Social Security taxes pay for benefits under the old age, survivors, and disability insurance part of the FICA. Medicare taxes pay for hospital benefits. Each employee contributes part of these taxes and the employer pays a matching amount. Self-employed taxpayers must also pay Social Security and Medicare taxes in the form of self-employment taxes.

The programs funded by employment taxes provide essential benefits to many citizens. The importance of the programs will continue to grow as more citizens reach retirement age.

Employment tax represents a significant portion of both Internal Revenue Service (IRS) receipts as well as an estimated significant portion of the tax gap.²

Taxpayers filed over 30 million employment tax returns in Fiscal Year (FY) 2004.³ These accounted for the largest component of business tax returns filed and the second largest component of all returns filed after individual income tax returns. The number of these tax returns is expected to increase over 9 percent by the year 2015.⁴ For FY 2004, over \$664 billion was reported as FICA payroll taxes. Self-employed taxpayers reported over \$41 billion in self-employment taxes for this same period.⁵

This review was performed on the Specialty Programs, Employment Tax Program and the Campus⁶ Compliance Services, Campus Reporting Compliance, Document Matching program at the IRS' National Headquarters in

¹ Federal Insurance Contributions Act, 26 U.S.C. §§ 3301-3128 (1939).

² The tax gap includes nonfilers, underreporters of tax, and underpayers of tax.

³ The 30 million returns are the Form 94X Series, IRS Data Book 2004, Publication 55B.

⁴ Calendar Year Return Projections for the United States and IRS Campuses: 2004-2011, Document 6186 (Rev.12-2004).

⁵ IRS Data Book 2004, Publication 55B.

⁶ The data processing arm of the IRS. The campuses 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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Significant Work Has Been Done in Employment Tax Compliance

Washington, D.C, and the Ogden, Utah, IRS Campus during the period January through April 2005. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS Small Business/Self Employment (SB/SE) Division has addressed employment tax compliance by including some self-employed taxpayers in the National Research Program (NRP)⁷ and by developing an employment tax strategy.

Self-employed taxpayers

Self-employed taxpayers file Form 1040 with Profit or Loss from Business (Schedule C), Supplemental Income and Loss (Schedule E), or Profit or Loss from Farming (Schedule F) to report their income and profits. They file Schedule SE to pay self-employment tax on their net earnings from self-employment.

Over the course of 3 years, the IRS implemented the NRP by randomly selecting about 46,000 returns for review and examination. These audits were largely completed by the fall of 2004. To gather statistically valid data, the return selection process for the NRP included an overall sampling of high-income returns. This enabled IRS researchers to draw valid conclusions about important subcategories of taxpayers.

For instance, slightly more than 6 percent of individual taxpayers filed Schedule C as sole proprietors in Tax Year (TY) 2001. These taxpayers reflect a wide range of economic activity. To draw valid conclusions on Schedule C filers, the NRP examined about 21,000 individuals who filed a Schedule C, slightly less than 46 percent of the total sample.

The IRS now estimates taxpayers who file self-employment tax returns contribute between \$51 and \$56 billion to the employment tax gap. As a result of the work completed on

⁷ The NRP was designed to measure individual taxpayer reporting compliance for Tax Year 2001.

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the NRP, the IRS believes it has an accurate picture of self-employed taxpayer compliance.

Employment tax strategy

Forms 941 were not in the plans for the NRP, but the IRS knew it needed to develop an employment tax strategy to administer an effective employment tax program. The SB/SE Division chartered a group of representatives to draft an SB/SE Division employment tax strategy that would guide the identification of critical issues and the selection of programs and initiatives to address reporting, filing, and payment noncompliance.

The IRS employment tax strategy evolved over a period of years. There were at least 3 separate versions of the strategy issued by the SB/SE Division over a 2-year period.

In a version dated February 24, 2004, the IRS weighted 13 areas of employment compliance by assigning a score. The higher the score, the more significant the effect on employment tax compliance and the tax gap. Scores were based on the number of taxpayers affected, the effect on the tax gap, the growth of the area, the geography or how much of the country was affected, the impact on resources, and the IRS mission. After the scores were assigned, the 13 areas of employment tax compliance were ranked.

A more concise strategy was developed on December 15, 2004, to better focus resources on noncompliance and reducing the employment tax gap. There are seven categories in the strategy. They are Tip Income, Non-Filers, Reporting Compliance, Workload Identification, Collection, Legislative Initiatives, and Education. Non-Filer and noncompliance by filers was seen as particularly corrosive to the tax system and considered an area of emphasis.

The reporting compliance portion of the employment tax strategy has two parts. The Employment Tax Examination Program (ETEP) and the 1120S⁸-Officer Compensation Compliance Initiative Project (CIP).

The ETEP uses certain information returns filed by corporations to identify misclassified workers. Employers

⁸ The Form 1120S is used by S corporations, which are granted special tax status as specified under the Internal Revenue Code.

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need to classify workers as either employees or independent contractors to determine their employment tax liability.

Employers do not pay employment taxes on compensation paid to independent contractors.

The 1120S-Officer Compensation CIP determines whether officers who perform services for their S Corporations are being paid a salary, or if they are receiving distributions to avoid paying employment taxes.

Consequently, the SB/SE Division's reporting compliance strategy identifies businesses that should pay additional employment taxes. Some individuals are not properly classified as employees on business returns, and some 1120S Corporations fail to recognize a reasonable salary to the officer shareholders when they actively operate a business and perform services. This results in the officer shareholder paying little or no employment taxes.

Methodologies Are Needed to Enhance the Employment Tax Strategy

Tax data reported on employment tax series Forms 94X, as mentioned in the background section of this report, have not been evaluated for over 15 years. Approximately two-thirds of all revenue receipts are reported on the Forms 941. The items reported on the Forms 941 include Social Security tax, Medicare tax, and Federal income tax withholding and totaled nearly \$1.4 trillion during FY 2004. However, the IRS does not know the current level of reporting compliance. There are currently no plans to include these returns in the IRS' NRP to measure reporting compliance.

Contributing to this lack of information is the limited number of examinations the IRS conducts on these returns. The examination rate for employment tax returns is less than a tenth of one-percent, the lowest rate of any business tax return.⁹

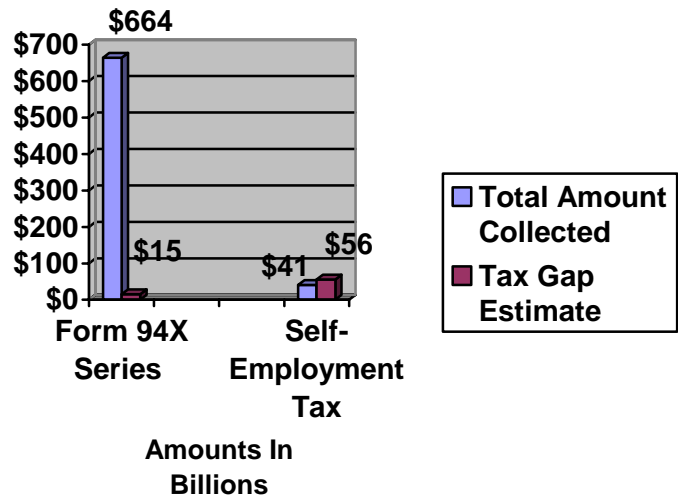
The current employment tax underreporting data for these returns is unreliable and has a significant adverse impact on developing an overall effective employment tax strategy. As previously mentioned, reporting compliance for individual taxpayers who are self-employed has been evaluated. While significant, these taxpayers only report \$41 billion dollars in tax on their forms, contrasted with

⁹ IRS Data Book 2004, Publication 55B.

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\$664 billion reported on Forms 94X. As illustrated in Figure 1, reporting compliance has not been measured for the largest portion of employment tax revenues.

Figure 1: Business Tax Forms



Source: IRS 2004 Data Book. The IRS' tax gap estimate for the Form 94X series which includes Medicare, Social Security, and Unemployment taxes is \$15 billion. The estimate is over 15 years old. The tax gap estimate of \$56 billion on self-employment taxes is a result of a recently completed NRP.

While the President and Congress debate over fixing the Social Security system to ensure future recipients have benefits, the IRS does not know whether all Social Security taxes are being reported and paid.

Potential methodologies to enhance the employment tax strategy

The actions planned by the IRS to address employment tax reporting compliance, if carried out, will have a positive effect on reducing the tax gap. However, the IRS has existing data that can be used to address other areas of employment tax reporting compliance. The IRS can use both its Combined Annual Wage Reporting (CAWR) program and its Examination program to enhance its employment tax strategy and reduce the tax gap.

The CAWR program helps the Social Security Administration (SSA) ensure all workers get credit for the wages they earn towards retirement benefits.

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When employers file the Forms 941, they also file Wage and Tax Statements (Form W-2) for their employees. Ideally, the amounts on the Forms W-2 should match those reported on Forms 941.

The SSA identifies employers who report more wages on the Forms 941 than what they report on the Forms W-2 because of concerns over missing Forms W-2. If the Forms W-2 are missing, it could indicate workers are not getting credit for the wages they earned towards Social Security retirement benefits. The IRS' CAWR program contacts the employer to determine whether there are any missing Forms W-2.

When employers report more wages on their Forms W-2 than on Forms 941, there could be unreported and, therefore, unpaid tax. These are called IRS-CAWR cases. The IRS has recently decided to work these cases and the results show promise. The IRS does not examine many Forms 941, but when they do, the examinations produce tax revenue.

Figure 2 illustrates when employment tax forms are reviewed the results are significant.

Figure 2: Results of Employment Tax Forms When Reviewed

<i>IRS Function</i>	<i>Year</i>	<i>Returns Reviewed</i>	<i>Additional Tax Assessed</i>
CAWR	Tax Year 2002	58,416	\$905,249,357
EXAMINATION	Fiscal Year 2004	17,698	\$422,264,000

Source: The Examination data were obtained from the IRS 2004 Data Book. The CAWR program data were obtained from the IRS SB/SE Division's Campus Compliance Services, Campus Reporting Compliance, Document Matching function. The data were the latest available.

The CAWR program reviewed TY 2002 Forms 941 and the IRS assessed over \$900 million. When all types of

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employment tax forms in the employment series were reviewed by Examination, they assessed over \$400 million. Over \$1 billion dollars of additional tax was assessed between the 2 IRS programs.

The SB/SE Division Employment Tax Program is going to examine 8,000 returns originating from the CAWR program and over 100,000 CAWR returns will be reviewed by the campuses in FY 2005. According to IRS figures, there are 720,612 Forms 941 for TY 2003 nationwide that might owe tax.

When the IRS' CAWR program and Examination function review employment tax forms, they discover significant inaccuracies. The use of these programs can provide the IRS with significant data on employment tax compliance and the tax gap. This data can be used to formulate a more focused employment tax strategy that addresses more significant areas of noncompliance.

The IRS should continue to evaluate components of employment tax underreporting to obtain accurate measures of compliance. Better data will help the IRS identify noncompliant segments of the population and will enhance development of methodologies to address employment tax reporting compliance.

Recommendation

1. We recommend the Commissioner, SB/SE Division, within the Employment Tax Strategy, develop methodologies designed to evaluate the extent of underreporting by employers. Consideration should be given to incorporating the Form 941 in the SB/SE Division's NRP program through the examination process, or using the CAWR program to evaluate the accuracy of employment tax data reported on Form 941.

Management's Response: As a component of the overall Employment Tax Strategy, the SB/SE Division will develop methodologies to evaluate the extent of employment tax underreporting by working with the Office of Research, Analysis, and Statistics of Income (RAS) to analyze the results of the employment tax questions included in the

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NRP Phase I. The SB/SE Division will also discuss with RAS the inclusion of appropriate questions regarding Form 941 in the next NRP Study. Phase II of the NRP will focus on flow-through entities and is scheduled to begin in FY 2006. The SB/SE Division will use the CAWR program as a source of employment tax examinations and incorporate the results of these examinations into its measures of reporting compliance.

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) has an effective strategy to measure employment tax reporting compliance. To accomplish our objective, we:

- I. Assessed the significance of employment taxes.
 - A. Determined what comprises employment taxes and obtained the latest IRS statistics on the number of employment tax returns filed and the respective dollar amounts reported.
 - B. Determined the relevance of employment tax returns by comparing the volume filed and the tax reported to other business tax returns.
 - C. Obtained and evaluated data from the IRS and other sources on an estimation of employment tax reporting noncompliance.
- II. Evaluated the employment tax compliance strategy and the goals the strategy is designed to achieve.
 - A. Determined if the Small Business/Self Employed (SB/SE) Division has a strategy to deal with employment tax noncompliance. We determined the status of the strategy and the stage of development or implementation.
 - B. Reviewed and evaluated the components and actions of the strategy to determine if they will adequately address employment tax noncompliance.
 - C. Determined if the components and actions of the employment tax compliance strategy include incorporating the IRS' Combined Annual Wage Reporting program and inclusion in the National Research Program.¹
 - D. Determined how the strategy was developed and whether it addressed employment tax noncompliance and, if not, whether and how the IRS otherwise evaluated where the employment tax noncompliance exists.
 - E. Determined if the strategy is consistent with other SB/SE Division and IRS compliance strategies.

¹ The NRP was designed to measure individual taxpayer reporting compliance for Tax Year 2001.

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- F. Evaluated SB/SE Division plans for coordination and communication with other operating divisions and other compliance components to develop an overall IRS employment tax strategy that will achieve the highest possible rate of compliance.
- III. Determined if the SB/SE Division has adequate plans for monitoring and measuring the employment tax strategy's progress and results.
- A. Determined and evaluated how the employment tax strategy will be measured and evaluated to reduce noncompliance.
 - B. Reviewed other audits conducted by the Treasury Inspector General for Tax Administration or Government Accountability Office that addressed employment tax noncompliance and other issues. Determined if the recommendations were addressed and implemented.

Major Contributors to This Report

Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Richard J. Dagliolo, Director
John J. Chiappino, Audit Manager
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Management's Response to the Draft Report



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

RECEIVED
JUL 28 2005

July 25, 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Additional Work is Needed to Determine the
Extent of Employment Tax Underreporting (Audit #200530006)

We have reviewed your draft report and appreciate your acknowledgement of the Small Business/Self-Employed (SB/SE) Division's comprehensive Employment Tax Strategy. We agree with your assessment that additional analysis is needed to determine the extent of employment tax underreporting and concur with your recommendation for enhancement in this area.

The SB/SE Employment Tax Strategy incorporates a number of Servicewide initiatives which address specific areas of noncompliance while simultaneously addressing the Tax Gap. The current Strategy balances many facets of employment tax compliance, including filing, payment, and reporting compliance. We consider the filing compliance portion of this Strategy to be an area of emphasis because employment tax non-filers are particularly corrosive to the tax system.

Our comments on your recommendation follow:

RECOMMENDATION

Develop methodologies within the Employment Tax Strategy designed to evaluate the extent of underreporting by employers. Consideration should be given to incorporating the Form 941 in the National Research Program (NRP) through the examination process, or consider using the Combined Annual Wage Reporting (CAWR) program to evaluate the accuracy of employment tax data reported on Form 941.

CORRECTIVE ACTION

As a component of the overall Employment Tax Strategy, SB/SE will develop methodologies to evaluate the extent of employment tax underreporting by:

- Working with the Office of Research, Analysis and Statistics of Income (RAS) to analyze the results of the employment tax questions included in NRP Phase I.

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- Discussing with RAS the inclusion of appropriate questions regarding Form 941 in the next NRP Study. Phase II of NRP will focus on flow-through entities and is scheduled to begin in Fiscal Year 2006.
- Using the CAWR Program as a source of employment tax examinations and incorporating the results of these examinations into our measures of reporting compliance.

IMPLEMENTATION DATE

October 15, 2006

RESPONSIBLE OFFICIAL

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The Chief, Employment Tax Operations, will advise the Director, Specialty Programs, of any corrective action delays.

If you have any questions or concerns, please contact me at (202) 622-0600 or Bill Conlon, Director, Specialty Programs, SB/SE Division, at (202) 283-7660.