



*More Complete and Accurate Data Are
Needed to Assess the Impact of Actions to
Address Compliance Reporting of State and
Local Government Entities*

June 8, 2007

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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

June 8, 2007

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – More Complete and Accurate Data Are Needed to
Assess the Impact of Actions to Address Compliance Reporting of
State and Local Government Entities (Audit # 200610045)

This report presents the results of our review to determine the impact of actions taken by the Federal, State, and Local Governments office (hereafter referred to as the FSLG office or the Office) to improve State and local government entities' compliance with information return filing and backup withholding¹ requirements. This audit was conducted as part of the Treasury Inspector General for Tax Administration's Office of Audit Fiscal Year 2007 Annual Audit Plan.

The Internal Revenue Code requires any service recipient, including government agencies, to file with the Internal Revenue Service (IRS) an annual information return for payments made to any person for services totaling \$600 or more during a calendar year.² Due to prior attention to the compliance reporting of Federal Government agencies by the Government Accountability Office,³ our review focused on information return filing and backup withholding compliance by State and local government entities.

¹ Internal Revenue Code Section 3406 (2005) requires that payers withhold Federal income tax and forward it to the Internal Revenue Service if a payee fails to provide the payer with a correct Taxpayer Identification Number and, upon notice, fails to provide a correct Taxpayer Identification Number. This is known as backup withholding.

² Internal Revenue Code Section 6041A (2005).

³ A Government Accountability Office review (*Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns* (GAO-04-74, dated December 2003)) of Federal Government agencies found significant compliance issues involving information return filing and backup withholding. Specifically, about \$5 billion in payments from agencies within 3 Federal Government departments to 152,000 payees during Tax Years 2000 and 2001 were not reported to the IRS on a Miscellaneous Income (Form 1099-MISC) information return as required. A tax year is an annual accounting period for keeping records and reporting income and expenses.



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Impact on the Taxpayer

Payments by FSLG office customers represent a large part of the national economy. Annually, Federal, State, and local governments purchase goods and services of more than \$2.5 trillion that potentially affect information return and backup withholding requirements. Because of the potential volume and dollar amount of the information returns issued by governments, any omissions could affect the tax gap⁴ if the income paid by governments is not reported to the IRS and reflected on the individuals' tax returns. In addition to the immediate compliance concern, this noncompliance threatens the perceptions of fairness and accountability that are at the foundation of the voluntary tax compliance system.

Synopsis

The FSLG office is taking some actions to address State and local government entities' information return filing and backup withholding requirements, including performing research during the case selection process to identify potential noncompliance in these areas. In addition, information return filing and backup withholding compliance by State and local government entities was being addressed through a combination of focused outreach efforts and the development of new educational products in Fiscal Years 2005 and 2006. Although the Office has made progress in this area, its database contained inaccurate and incomplete information related to the disposition and productivity in 21 (30 percent) of 71 cases we reviewed. As a result, we could not determine the overall impact of actions taken by the FSLG office to improve State and local government entities' compliance with information return filing and backup withholding requirements. Continued emphasis by the Office in this area and more accurate information related to its compliance check and examination efforts will provide assurance that Office customers file all necessary information returns and tax revenue is accurately reported as required.

Recommendations

We recommended the Director, FSLG, (1) reemphasize and update existing guidelines for completing the case selection survey sheet used to track the disposition and productivity of closed compliance contacts, (2) update the FSLG office's database with the compliance information on the large non-Federal Government entity examinations closed in Fiscal Years 2005 and 2006 and ensure future initiatives are tracked on the database, and (3) review our analyses of State and local government entities' information return filings for

⁴ The difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law.



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Tax Years 2003 – 2005 to determine if potential compliance activities are warranted and if revisions to the current classification process are necessary to better identify potential nonfilers.

Response

The Commissioner, Tax Exempt and Government Entities Division, agreed with the finding and recommendations contained in the report. The FSLG office has reemphasized existing guidelines on the completion of the case selection survey sheet and plans to issue an all-employee memorandum to provide clarity and additional direction. The Office has identified all large non-Federal Government entity examinations completed in Fiscal Years 2005 and 2006 that should be tracked on its database, plans to gather and input the related compliance information, and plans to track future initiatives on the database as appropriate. Finally, the FSLG office plans to review the analysis we completed relating to State and local government entities' filings of Miscellaneous Income (Form 1099-MISC) information returns to determine if compliance activities are warranted. The Office plans to consider developing a possible Form 1099-MISC nonfiler compliance project. Management's complete response to the draft report is included as Appendix V.

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 Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



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Abbreviations

FSLG	Federal, State, and Local Governments
FY	Fiscal Year
IRS	Internal Revenue Service
TIN	Taxpayer Identification Number



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Background

The Federal, State, and Local Governments office (hereafter referred to as the FSLG office or the Office)¹ is responsible for providing top-quality service to more than 87,000 Federal Government agencies, State Governments, local governments, and quasi-governmental entities by helping them understand and comply with the tax laws. FSLG office customers are generally not subject to Federal income tax but are required to file information returns and to file and pay employment taxes for their more than 23 million employees (20 percent of the United States workforce). The Office focuses its compliance efforts to ensure employment tax returns are accurately filed and paid and information returns are accurately filed. FSLG office entities pay wages in excess of \$760 billion and pay employment taxes in excess of \$200 billion annually.

The Internal Revenue Code requires any service recipient, including government agencies, to file with the Internal Revenue Service (IRS) an annual information return for payments made to any person for services totaling \$600 or more during a calendar year.² Payments to corporations for certain services provided must also be reported, such as attorneys' fees and medical and health care payments. In addition, Federal Government executive agencies must report all payments for services provided by vendors, including payments made to corporations. A Miscellaneous Income (Form 1099-MISC) information return is used to report service payments and includes the names, addresses, and Taxpayer Identification Numbers (TIN)³ of the payer and the payee and the total amount paid during the year for the services provided. The IRS enters information on the Forms 1099 into its computer systems and matches these data with the payees' income tax returns to determine whether taxpayers have filed returns and reported all of their income. A correct TIN is necessary to enable the IRS to match these returns.

Although government agencies should be models of tax compliance, there are significant concerns in this area. A December 2003 Government Accountability Office review⁴ of Federal Government agencies found significant compliance issues involving information return filing and backup withholding.⁵ Specifically, the Government Accountability Office found that about \$5 billion in payments from agencies within 3 Federal Government departments to

¹ The FSLG office is part of the Government Entities function in the Tax Exempt and Government Entities Division.

² Internal Revenue Code Section 6041A (2005).

³ The TIN is a nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the TIN is an Employer Identification Number, a Social Security Number, or an Individual TIN.

⁴ *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns* (GAO-04-74, dated December 2003).

⁵ Internal Revenue Code Section 3406 (2005) requires that payers withhold Federal income tax and forward it to the IRS if a payee fails to provide the payer with a correct TIN and, upon notice, fails to provide a correct TIN. This is known as backup withholding.



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152,000 payees during Tax Years⁶ 2000 and 2001 were not reported to the IRS on Forms 1099-MISC as required. Approximately 8,800 of these payees had received \$421 million in payments yet had failed to file tax returns for these years. In addition, the Government Accountability Office stated that approximately \$20 billion in payments reported to the IRS on 170,000 information returns for Tax Years 2000 and 2001 included invalid vendor⁷ TINs. As a result of these concerns, the FSLG office began an initiative to address TIN matching by Federal Government agency vendors.

To support the IRS and the Tax Exempt and Government Entities Division strategic goals of enhancing enforcement of the tax law, the FSLG office committed in its Fiscal Year (FY) 2006 Work Plan to expand compliance enforcement activity and to understand and improve compliance. To accomplish this goal, the Office is working with government entities to improve compliance with backup withholding requirements and information returns reporting. Reporting compliance (the proper filing of Forms 1099) is being addressed through field compliance contacts.⁸ Also, in an effort to reduce the tax gap,⁹ the FY 2008 Federal budget requested by the President contained several new reporting proposals for tax changes involving payments that are subject to information return filing. Due to prior attention to compliance reporting of Federal Government agencies by the Government Accountability Office, our review focused on the information return filing and backup withholding compliance by State and local government entities.

This review was performed at the Tax Exempt and Government Entities Division Headquarters in Washington, D.C., and the FSLG office Compliance and Program Management office in Austin, Texas, during the period August 2006 through January 2007. 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.

⁶ A tax year is an annual accounting period for keeping records and reporting income and expenses.

⁷ A vendor is a company that supplies parts or service to another company.

⁸ Compliance contact cases collectively refer to examinations and compliance checks. A compliance check is a contact with the customer that involves a review of filed information and tax returns of the entity. A compliance check does not directly relate to determining a tax liability for any particular tax period, and a customer may legally choose not to participate in a compliance check.

⁹ The difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law.



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Results of Review

More Complete and Accurate Data Are Needed to Assess the Impact of Actions Being Taken to Address Information Return Reporting and Backup Withholding Compliance

FSLG office management is taking some actions to address State and local government entities' compliance with information return filing and backup withholding requirements. These actions are part of the Office's increased emphasis since FY 2004 to focus more of its resources on compliance activities. The Office is performing research during the case selection process to identify potential noncompliance relating to information reporting and backup withholding. Specifically, Office personnel run certain predefined Returns Inventory and Classification System¹⁰ queries to identify areas of noncompliance then judgmentally prioritize these cases for assignment to the field based on potential noncompliance indicators. In addition, information return filing and backup withholding compliance by State and local government entities was being addressed through a combination of focused outreach efforts and the development of new educational products in FYs 2005 and 2006.

In response to a prior Treasury Inspector General for Tax Administration report,¹¹ FSLG office management had acknowledged that effective workload planning for compliance contact cases is a challenge due to the lack of Office compliance benchmarks and baseline measures developed to date. Management had indicated they did not have accurate and statistically valid data related to compliance levels and indicators of noncompliance to assist them in selecting productive cases for review. As a result of our recommendations, management initiated changes in March 2006 to improve their ability to track results of compliance activities and allow for more systemic analysis of past compliance work. Although the FLSG office has made progress in this area, we determined the Office's database¹² contained inaccurate or incomplete information related to case disposition and productivity in 21 (30 percent) of 71 cases reviewed in our sample.¹³ As a result,

¹⁰ This System contains return and filer information related to the filing and processing of employee plan, exempt organization, and government entity forms.

¹¹ *The Federal, State, and Local Governments Office Can Improve the Workload Selection Process to Increase Effectiveness* (Reference Number 2006-10-073, dated April 2006).

¹² The FSLG office database contains approximately 7,800 records and provides feedback on the quality and productivity of the case selection process and the results of the compliance activities.

¹³ We chose and reviewed a sample of 83 cases to determine if the cases included a review for information return filing and backup withholding issues. A total of 71 of these 83 cases were on the Office database; we reviewed the 71 cases to determine if case information and results were properly recorded on the database. See Appendix I for detailed information on our sampling methodology.



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we could not determine the overall impact of actions taken by the Office to improve State and local government entities' compliance with information return filing and backup withholding requirements.

Payments by FSLG office customers represent a large part of the national economy. Because of the potential volume and dollar amount of the information returns issued by governments, any omissions could affect the tax gap if the income paid by governments is not reported to the IRS and reflected on the individuals' tax returns. In addition to the immediate compliance concern, this noncompliance threatens the perceptions of fairness and accountability that are at the foundation of the voluntary tax compliance system.

Continued emphasis by the FSLG office in this area and more accurate information related to its compliance check and examination efforts will provide assurance that Office customers file all necessary information returns and tax revenue is accurately reported as required.

Annually, Federal, State, and local governments purchase goods and services of more than \$2.5 trillion that potentially affect information return and backup withholding requirements.

The FSLG office is taking actions to address information return filing and backup withholding requirements

Based on reviews of 83 compliance check and examination cases, we determined FSLG office specialists generally address information return filing and backup withholding during compliance checks and examinations. Specifically, documentation in the case files showed specialists reviewed the State or local government entities' filings of Forms 1099-MISC and processes for addressing information return filing and backup withholding requirements. When noncompliance was identified, the specialists generally addressed the specific issues with the government entities by issuing discrepancy letters, securing delinquent returns, and/or assessing additional tax and penalties, when appropriate. In addition, documentation in both the compliance check and examination case files indicated specialists generally addressed the government entities' processes for addressing backup withholding, particularly if mismatched/missing TINs were identified. We determined specialists (1) made additional tax assessments in 24 (69 percent) of the 35 sampled examination cases reviewed and (2) issued discrepancy letters identifying findings and made corrective recommendations in 25 (52 percent) of the 48 sampled compliance check cases.

We also determined FSLG office management uses a case selection system that includes specific criteria to identify potential noncompliance as it relates to information return filing and backup withholding requirements. This process includes performing Returns Inventory and Classification System queries, judgmentally prioritizing cases based on potential noncompliance indicators identified from those queries, and determining the appropriate type of compliance activity to conduct (examination versus compliance check). Specifically, Office personnel



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analyze information return and backup withholding data to select compliance cases for Office field specialists.

The FSLG office Work Plan for FY 2006 states the Office will address key areas of noncompliance through compliance activities and a combination of focused outreach and development of new educational products. We determined the Office had performed education and outreach activities to improve State and local government entities' information return filing and backup withholding compliance. Specifically, the Office participated in 228 activities designed to increase State and local government entities' awareness of filing compliance issues during FYs 2005 and 2006. We judgmentally sampled 20 of these outreach activities and determined Office specialists presented information and materials specifically related to filing requirements for Forms 1099-MISC, the types of payments that should be reported on Forms 1099-MISC, the definition of backup withholding, what payments are subject to backup withholding, and when backup withholding is required. Office management indicated outside entities may request outreach through Office specialists, or specialists may contact outside organizations and offer to conduct presentations on topics of interest to the organizations.

In June 2006, FSLG office management put various pertinent reference guides on the IRS Internet web site (IRS.gov) for State and local government entities' officials to access when performing research. The web site includes information such as the *Public Employer Tax Guide*, the *Taxable Fringe Benefits Guide*, fact sheets on information return filing and backup withholding for State and local government entities, and a "toolkit" for government entity payroll officers. The toolkit was developed in response to a recommendation by the Advisory Committee on Tax Exempt and Government Entities¹⁴ to provide on the IRS web site a single location for government entity employers to obtain information about tax withholding and compliance issues. In addition, the Office publishes a semi-annual Newsletter that provides articles on information return filing that is available on IRS.gov; it is transmitted to thousands of subscribers. Although the Office does not measure the impact of its outreach activities on compliance, management believes their outreach efforts address common questions from government entities on tax withholding and compliance issues.

More complete and accurate data are needed to assess the impact of the FSLG office's compliance work

Our review of 71 sampled compliance checks and examinations of State and local government entities determined case information and results were not always accurately or completely recorded on the FSLG office database used to track compliance information. We also determined the Office database does not include the results for some examinations of large non-Federal Government entities closed in FYs 2005 and 2006.

¹⁴ This Committee is a formal body of external stakeholders in the specialized areas of tax-exempt organizations; employee retirement plans; tax-exempt bonds; and Federal, State, local and Indian tribal governments.



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Specifically, our review of 71 sampled cases determined 21 (30 percent) had inaccurate and/or incomplete database information about the disposition and productivity of the compliance activities (compliance checks and examinations).¹⁵ The Office database contained the following inaccurate or incomplete information:¹⁶

- The reason why the case was selected for compliance work (four cases).
- The productivity of the case selection criteria (eight cases).
- The number of delinquent information returns secured and/or the associated payments made (seven cases).
- Whether penalties or employment taxes were assessed (four cases).
- The final disposition of the compliance checks (two cases).
- Whether educational actions were completed by the field (three cases).

This information would assist FLSG office management in determining the case selection criteria that resulted in identification of the most productive casework, provide baseline measures of the level of noncompliance identified, and identify actions taken to improve the noncompliance. The database inaccuracies and omissions in the specific case reviews can be attributed mostly to improper completion of the survey sheets by Office specialists, oversights during input of the case closing information to the database, and possible transcription errors.

In addition, FSLG office management had committed to implementing a compliance program that addresses large non-Federal Government entities in FY 2005 and plans to continue this strategic initiative into FY 2007. These large non-Federal Government entities, with annual payrolls in excess of \$40 million, have generally never been examined.¹⁷ These organizations employ over 80 percent of all non-Federal Government workers and are large enough to have a significant impact on the Social Security and Medicare trust funds. However, we determined the Office database did not include the results of some examinations of large non-Federal Government entities closed in FYs 2005 and 2006. Specifically, we obtained inventory lists from Office management and identified 26 cases representing 23 unique large non-Federal Government entities selected for examination during the Office case selection process that were closed in FYs 2005 and 2006 (as of July 20, 2006). We determined 19 of these 26 cases shown

¹⁵ See Appendix IV for details.

¹⁶ The identified issues total more than the 21 cited cases because some cases involved more than 1 inaccurate or incomplete issue.

¹⁷ The FSLG office was established in FY 2000 as part of the IRS' modernization process. As a result, during the initial years, the Office focused primarily on outreach and education to help customers understand IRS filing and reporting requirements and how to accurately and timely file tax and any other required returns. Beginning in FY 2004, the Office took actions to achieve a better balance between educational and compliance activities.



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on the Office inventory lists had not been recorded on the Office database as of that date.¹⁸ Office management believed these cases were not recorded on the database because they were initiated before implementation of the database and the case selection survey sheet.

FSLG office management should ensure the Office database contains accurate and complete compliance information about large non-Federal Government entities, to identify future compliance actions and address customer outreach and education. Office management cannot accurately assess the effectiveness of their compliance efforts, or whether the cases selected are identifying significant areas of noncompliance that can be addressed by future education and compliance activities, if the database information is inaccurate and incomplete. By ensuring complete and accurate information is captured about compliance activities, management will have reliable and sufficient information for future analysis. This should enable them to use resources more productively by focusing on the returns with the highest risk of noncompliance, identifying potential issues for future compliance action, and addressing customer education needs.

Analysis of the IRS computer system identified potential information reporting noncompliance

FSLG office personnel analyze information return filing and backup withholding data during the case selection process using Returns Inventory and Classification System queries to identify potential noncompliance by Federal, State, and local government agencies. Cases with potential noncompliance indicators are selected for compliance activity based on results of the Returns Inventory and Classification System queries.

Our analysis of Form 1099-MISC data for Tax Years 2003 through 2005 identified from IRS Business Master File¹⁹ and Payer Master File²⁰ data showed filing trends that may be indicative of information return filing noncompliance. We did not determine whether these entities were still in existence or should have filed Forms 1099 or whether the FSLG office had previously identified any of these entities during its case selection process. However, we identified the following general indicators of noncompliance related to State and local government entities:

- Some did not file any Forms 1099-MISC for Tax Years 2003 through 2005.
- Some filed Forms 1099-MISC for Tax Years 2003 and 2004 but did not file Forms 1099-MISC for Tax Year 2005.

¹⁸ See Appendix IV for details.

¹⁹ The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

²⁰ The IRS database that consists of a list of business and individual entities filing Form 1099 (this is the information return series of tax forms). The file also contains information for each payer on penalties proposed and assessed.



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- Some filed Forms 1099-MISC for Tax Years 2003 and 2005 but did not file Forms 1099-MISC for the intervening year (Tax Year 2004).

Figure 1 summarizes the filing trends for 81,080 State and local government entities we reviewed.

Figure 1: State and Local Government Entities' Filing Trends (Form 1099-MISC)

Were Forms 1099-MISC filed?			
Tax Year 2003	Tax Year 2004	Tax Year 2005	Number of Entities With the Various Filing Trends for Tax Years 2003-2005
Yes	Yes	No	2,267
Yes	No	Yes	1,338
No	Yes	Yes	2,757
No	Yes	No	979
Yes	No	No	1,714
No	No	Yes	2,208
No	No	No	24,528

Source: Our analysis of the IRS Payer Master File information relating to State and local government entities' filings of Forms 1099-MISC for Tax Years 2003 – 2005.

At the end of our fieldwork, we provided the FSLG office Compliance and Program Management office with these results. Office management agreed to review this information to determine if any actions are warranted.

Recommendations

The Director, FSLG, should:

Recommendation 1: Reemphasize and update existing guidelines on how the case selection survey sheet should be completed. This should include guidance on:

- Identifying the specific criteria used to select the compliance contact.
- Reporting on the productivity of each case selection criterion used.



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- Reporting accurate and complete results of the compliance contacts, such as the number of delinquent information returns secured and the associated payments made, whether penalties or employment taxes were assessed, and the final disposition of the case.
- Ensuring a separate case selection survey sheet is completed, when appropriate, for compliance contacts to ensure case results are separately tracked on the Office database.

Management's Response: IRS management agreed with this recommendation. The FSLG office reemphasized the existing guidelines on how the case selection survey sheet should be completed during its annual Continuing Professional Education meeting held the week of May 1 – 3, 2007. In addition, the Office has reviewed the existing instructions related to completion of the case selection survey and plans to issue an all-employee memorandum to provide clarity and additional direction.

Recommendation 2: Update the FSLG office database with the compliance information on the large non-Federal Government entity examination cases completed in FYs 2005 and 2006 that should be tracked on the database and ensure any future initiatives are tracked on the database as appropriate.

Management's Response: IRS management agreed with this recommendation. The FSLG office has identified all large non-Federal government entity examinations completed in FYs 2005 and 2006 that should be tracked on its database. The Office plans to gather and input compliance information to the database for all cases on which compliance information has not been recorded and to track future initiatives on the database as appropriate.

Recommendation 3: Review our analyses of the IRS computer systems relating to State and local government entities' filings of Forms 1099-MISC for Tax Years 2003 – 2005 to determine if potential compliance activities for these entities are warranted and if revisions to the current classification process or additional data analyses are necessary to better identify potential nonfilers.

Management's Response: IRS management agreed with this recommendation. The FSLG office plans to review our analysis of State and local government entities' filings of Forms 1099-MISC to determine if compliance activities are warranted. The Office also plans to take into account the results of this analysis as it considers (1) developing a possible Form 1099-MISC nonfiler compliance project and (2) whether the results of the analysis may contribute to case selection criteria during the regular classification process.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine the impact of actions taken by the FSLG office (also referred to as the Office) to improve State and local government entities' compliance with information return filing and backup withholding¹ requirements. We determined the following internal controls² were relevant to our objective: the FSLG office's policies, procedures, and practices for improving State and local government entities' information return filing and backup withholding compliance. We reviewed these controls by interviewing Office management and analyzing the Office database³ and documentation related to Office compliance contacts. We did not identify any significant material weaknesses. To accomplish the audit objective, we:

- I. Determined what actions the FSLG office had planned or completed to improve State and local government entities' information return filing and backup withholding compliance.
 - A. Interviewed responsible Office personnel to determine the actions planned or completed to improve State and local government entities' information return filing and backup withholding compliance in FYs 2005 and 2006.
 - B. Determined whether closed compliance check cases and examinations⁴ included a review of information return filing and backup withholding issues and whether case information was properly recorded on the Office database.
 1. Reviewed a total sample of 83 compliance check and examination cases (from a total population of 290 cases) to determine whether the cases included a review for information return filing and backup withholding issues. We used a random sampling methodology for Steps I.B.1.a) - c) and Step I.B.1.e) to ensure each compliance check or examination case had an equal chance of being selected; this

¹ Internal Revenue Code Section 3406 (2005) requires that payers withhold Federal income tax and forward it to the IRS if a payee fails to provide the payer with a correct TIN and, upon notice, fails to provide a correct TIN. This is known as backup withholding.

² Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives; include the processes and procedures for planning, organizing, directing, and controlling program operations; and include the systems for measuring, reporting, and monitoring program performance.

³ The FSLG office database contains approximately 7,800 records and provides feedback on the quality and productivity of the case selection process and the results of the compliance activities.

⁴ Compliance contact cases collectively refer to examinations and compliance checks. A compliance check is a contact with the customer that involves a review of filed information and tax returns of the entity. A compliance check does not directly relate to determining a tax liability for any particular tax period, and a customer may legally choose not to participate in a compliance check.



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enabled us to obtain sufficient evidence to support our results. We had planned to review all of the cases for Step I.B.1.d). The sample consisted of:

- a) **Twenty-eight** of 58 completed compliance check cases closed during April 1, 2006, through July 20, 2006, on the Office database.
 - b) **Nineteen** of 26 completed examination cases closed during April 1, 2006, through July 20, 2006, on the Office database.
 - c) **Twelve** of 139 examinations involving large non-Federal Government entities closed during FYs 2005 and 2006 (as of August 29, 2006) that may have involved information return filing and/or backup withholding issues. These cases were sampled from automated inventory lists maintained by Office personnel.
 - d) **Four** of seven examination cases involving large non-Federal Government entities that were closed during FY 2006 (as of July 20, 2006). These cases were identified through review of the Office database. We requested all seven cases identified on the database but did not obtain three of the seven case files from the IRS for our review. Two of the cases had been transferred from the Federal Records Center to other IRS personnel. We did not receive a response for the third case.
 - e) **Twenty** of 60 follow-up compliance check cases closed as of July 31, 2006, associated with the Office project that had been initiated to follow up on prior year compliance check cases. These cases were on the Office database.
2. Reviewed the 71 compliance check and examination cases that were on the Office database (from Steps I.B.1.a), b), d) and e)) to determine whether case information and results were properly recorded on the database.
- C. Identified State and local government entities that may be noncompliant with information return filing.
1. Requested a data extract from the Treasury Inspector General for Tax Administration Office of Information Technology that identified 81,080 State and local government entities on the Business Master File.⁵ We performed checks to validate the accuracy of the extracted data and found no inaccuracies or missing information in the data records reviewed. In addition, we requested separate data extracts from the Payer Master File⁶ on the number of Miscellaneous Income

⁵ The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

⁶ The IRS database that consists of a list of business and individual entities filing Form 1099 (this is the information return series of tax forms). The file also contains information for each payer on penalties proposed and assessed.



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(Form 1099-MISC) information returns filed for Tax Years⁷ 2003 through 2005 for each of the 81,080 State and local government entities identified on the Business Master File. We performed tests and validated the accuracy of the extracted data. The Payer Master File data were then analyzed to identify Form 1099-MISC filing trends that may be indicative of information return filing noncompliance. We determined with reasonable assurance that we could rely on the filing trends of the State and local government entities identified.

- II. Determined whether FSLG office management had planned or completed any education and outreach activities in FYs 2005 and 2006 to improve State and local government entities' information return filing and backup withholding compliance.
 - A. Sampled 20 of the 228 education and outreach activities performed in FYs 2005 and 2006 to determine whether the activities were designed to increase State and local government entities' awareness of filing compliance issues. We used a judgmental sample due to time constraints and because we did not plan to project the results to the population.

⁷ A tax year is an annual accounting period for keeping records and reporting income and expenses.



*More Complete and Accurate Data Are Needed to Assess the
Impact of Actions to Address Compliance Reporting of
State and Local Government Entities*

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Gerald T. Hawkins, Acting Director
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Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
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Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE
Director, Office of Federal, State, and Local Governments, Tax Exempt and Government Entities
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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Director, Communications and Liaison, Tax Exempt and Governments Entities
Division SE:T:CL



More Complete and Accurate Data Are Needed to Assess the Impact of Actions to Address Compliance Reporting of State and Local Government Entities

Appendix IV

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 40 taxpayer accounts affected (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained the following 71 randomly sampled compliance check and examination cases¹ to determine if case information was properly recorded on the FSLG office (also referred to as the Office) database:²

- Twenty-eight of 58 completed compliance check cases closed during April 1, 2006, through July 20, 2006.
- Nineteen of 26 completed examination cases closed during April 1, 2006, through July 20, 2006.
- Four of seven examination cases involving large non-Federal Government entities that were closed during FY 2006 (as of July 20, 2006).
- Twenty of 60 closed follow-up compliance check cases closed as of July 31, 2006, associated with the Office project that had been initiated to follow up on prior year compliance check cases.

Based on our review of the sampled cases, we determined 21 of the cases had inaccurate and/or incomplete information on the FSLG office database related to case disposition and productivity.

In addition, we determined the FSLG office had implemented a compliance program to address large non-Federal Government entities. However, the Office database did not include the results for some of the examinations closed in FYs 2005 and 2006.

¹ Compliance contact cases collectively refer to examinations and compliance checks. A compliance check is a contact with the customer that involves a review of filed information and tax returns of the entity. A compliance check does not directly relate to determining a tax liability for any particular tax period, and a customer may legally choose not to participate in a compliance check.

² The FSLG office database contains approximately 7,800 records and provides feedback on the quality and productivity of the case selection process and the results of the compliance activities.



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Specifically, the records for 19 of 26 examination cases (representing 23 unique large non-Federal Government entities) closed in FYs 2005 and 2006 were not recorded on the Office database. The database should have included the specific criteria used to select the cases for review, whether the criteria were productive, the compliance issues addressed, and the closing results of the compliance contact (e.g., the number of delinquent returns secured and the dollar amounts and whether penalties and or employment taxes were asserted when applicable).

In total, we found 40 taxpayer accounts (21 + 19 = 40) for which information was inaccurate and/or incomplete on the FSLG office database.



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Appendix V

Management's Response to the Draft Report



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

RECEIVED
MAY 23 2007

MAY 23 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:  Steven T. Miller
Commissioner, Tax Exempt and Government Entities

SUBJECT: More Complete and Accurate Data Are Needed to Assess the
Impact of Actions Being Taken to Address Compliance
Reporting of State and Local Government Entities (Audit
#200610045)

I am pleased to respond to your report concerning the progress of the Federal, State and Local Governments office (FSLG) in addressing compliance by state and local governmental entities with requirements to file information returns and to engage in backup withholding. FSLG's efforts are designed to ensure compliance with Federal tax laws and to provide high quality service to the customers it serves.

Your report notes that FSLG has taken a number of steps toward these goals. These steps include compliance checks and examinations on the compliance side, and the posting to the IRS web site of pertinent publications and a toolkit for government payroll officers on the customer service side.

We appreciate your thoughtful recommendations, and agree with them. Our complete response to your recommendations appears in the attachment. We concur in your statement of the report's measurable benefit on tax administration.

If you have any questions, please call Karen Skinder, acting director, FSLG, at (216) 520-7052.



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Attachment

TE/GE Response to TIGTA Audit 200610045

RECOMMENDATION 1

The Director, Federal State and Local Governments, should reemphasize and update existing guidelines on how the case selection survey sheet should be completed. This should include guidance on:

- Identifying the specific criteria used to select the compliance contact.
- Reporting on the productivity of each of the case selection criterion used.
- Reporting accurate and complete results of the compliance contacts, such as the number of delinquent information returns secured and the associated payments made, whether penalties or employment taxes were assessed, and the final disposition of the case.
- Ensuring a separate case selection survey sheet is completed, when appropriate, for compliance contacts to ensure case results are separately tracked on the Office database.

CORRECTIVE ACTION 1

FSLG has reemphasized the existing guidelines on how the case selection survey sheet should be completed during its annual CPE the week of May 1 - 3, 2007. In addition, FSLG has reviewed the existing instructions related to completion of the case selection survey and will issue an all-employee memorandum to provide clarity and additional direction.

RESPONSIBLE OFFICIAL

Director, Government Entities

IMPLEMENTATION DATE 1

June 30, 2007

RECOMMENDATION 2

Update the FSLG office database with the compliance information on large non-Federal government entity examination cases completed in FYs 2005 and 2006 that should be tracked on the database and ensure any future initiatives are tracked on the database as appropriate.



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CORRECTIVE ACTION 2

FSLG has identified all large non-Federal government entity examinations completed in FYs 2005 and 2006 that should be tracked on the database. FSLG will gather and input compliance information into the database for all cases on which compliance information has not been recorded, and will track future initiatives on the database as appropriate.

RESPONSIBLE OFFICIAL

Director, Federal, State and Local Governments

IMPLEMENTATION DATE 2

September 30, 2007

RECOMMENDATION 3

Review the TIGTA analysis of the IRS computer systems relating to state and local government entities' filings of Forms 1099-MISC for Tax Years 2003 - 2005 to determine if potential compliance activities for these entities are warranted and if revisions to the current classification process or additional data analyses are necessary to better identify potential nonfilers.

CORRECTIVE ACTION 3

FSLG will review the analysis completed by TIGTA relating to state and local government entity filings of Forms 1099-MISC to determine if compliance activities are warranted. FSLG will also take into consideration the results of this analysis as it considers developing a possible Form 1099-MISC nonfiler compliance project, and will consider whether the results of the analysis may contribute to case selection criteria during the regular classification process.

RESPONSIBLE OFFICIAL

Director, Federal, State and Local Governments

IMPLEMENTATION DATE 3

December 31, 2007