



Mortgage Interest Data Could Be Used to Pursue More Nonfilers and Underreporters

August 6, 2009

Reference Number: 2009-40-112

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.

Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 6, 2009

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Mortgage Interest Data Could Be Used to Pursue
More Nonfilers and Underreporters (Audit # 200840025)

This report presents the results of our review to determine how effectively the Internal Revenue Service (IRS) uses Mortgage Interest Statements (Form 1098) to identify unreported income. The review was part of our Fiscal Year 2009 Annual Audit Plan under the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

Individuals who fail to file required returns and/or underreport their income can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. We recognize that, given the current state of the economy, many individuals are struggling to meet their mortgages and other financial obligations. Nevertheless, a large number of individuals are paying a significant amount of mortgage interest and either are not filing tax returns or are filing tax returns reporting income that is not sufficient to cover their mortgage obligations and basic living expenses. The considerable difference between income and expenditures on these returns raises serious questions about whether additional income should have been reported.

Synopsis

To its credit, the IRS recognizes the potential benefits of incorporating Forms 1098 into its compliance efforts and is using these documents in its Return Delinquency Program.¹ While this Program is experiencing success in identifying potential nonfilers, our samples of Forms 1098

¹ See Appendix VI for a glossary of terms.



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show the documents may also provide some good audit leads for use in the IRS Examination function.

We evaluated 2 statistically valid samples of 100 individuals with combined Forms 1098 totaling \$20,000 or more of mortgage interest that were filed with the IRS for Tax Year (TY) 2005.² For the first sample, we matched the taxpayer identification numbers on Forms 1098 meeting our criteria to accounts in the IRS Individual Return Transaction File and found 219,593 individuals without a corresponding tax return. From the 219,593 potential nonfilers, we randomly selected 100 for review and identified 21 individuals who appeared to have a filing requirement for TY 2005, but had yet to be contacted by the IRS.

To determine the amount of taxes the 21 potential nonfilers may owe, we used the IRS Examination function's cash transaction analysis process to obtain an estimate of each individual's taxable income. Next, we followed the IRS procedures for preparing proposed assessments in situations where a tax return was not filed and estimated that the 21 individuals may owe as much as \$177,715 in delinquent taxes and \$107,209 in penalties and interest. When projected to our population of 219,593 potential nonfilers, our results indicate that 46,115 potential nonfilers may collectively owe \$625 million in delinquent taxes, penalties, and interest for TY 2005. The projection is based on a 95 percent confidence level. We expect the number of potential nonfilers to fall between 28,500 and 63,729 with amounts owed ranging between \$351,894,360 and \$899,456,350.

In the second sample, we matched the taxpayer identification numbers on Forms 1098 meeting our criteria to the accounts in the IRS Individual Return Transaction File and identified 245,535 individuals who reported less adjusted gross income on the returns they filed for TY 2005 than the amount of mortgage interest reflected on their Forms 1098. After randomly selecting 100 of the 245,535 individual returns for review, we used the IRS' cash transaction analysis process and identified 37 individuals who may have underreported their income because their mortgage interest and basic living expenses appear to exceed their income. For example, we found

Overall, based on our sample results, we estimated that these 37 individuals may owe \$265,013 in additional taxes and \$61,233 in penalties and interest. When projected to our population of 245,535 filers, our results indicate that 90,848 taxpayers may owe \$801 million in additional taxes, penalties, and interest for TY 2005. The projection is based on a 95 percent confidence level. We expect the number of individuals with insufficient funds to fall between 67,501 and 114,195 with the amounts owed ranging between \$548,757,358 and \$1,053,363,428.

² We chose individuals with aggregate Forms 1098 reporting \$20,000 or more of mortgage interest because it would enable us to focus our efforts on those who were more likely to have higher incomes.



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It is important to note that we do not know if the potential nonfilers identified in our review were, in fact, required to file tax returns. Nor do we know, without an IRS examination, if the potential underreporters owe additional taxes, penalties, and interest. However, Examination function officials reviewed our results and agreed with the conclusions. In addition, an outside statistician confirmed the accuracy and validity of our sampling methodologies as well as our projections.

Recommendation

Given the potential compliance implications and revenue at stake, we recommended that the Director, Examination, Small Business/Self-Employed Division, explore the feasibility of making greater use of mortgage interest data to pursue additional nonfilers and underreporters for audit.

Response

IRS management agreed with our recommendation and will expand an existing Area-wide Compliance Initiative Project on the mortgage interest deduction to a Nationwide Compliance Initiative Project. IRS management also indicated that the Small Business/Self-Employed Division will form a task team to study the existing processes for identifying nonfiler workload to ensure that mortgage interest is appropriately considered in selecting nonfiler cases for delivery to examiners. Management's complete response to the draft report is included as Appendix VII.

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 Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.



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Abbreviations

IRS	Internal Revenue Service
TY	Tax Year



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Background

At the end of each tax year, Federal law requires financial institutions to provide the Internal Revenue Service (IRS) with Mortgage Interest Statements (Form 1098) detailing the amount of interest received from the mortgages they hold. Besides identifying the amount of mortgage interest received, the law requires financial institutions to identify the names and taxpayer identification numbers of the individual borrowers on the Form 1098 and provide a copy of the document to the borrower responsible for paying the interest. Individuals, in turn, use the documents to report their mortgage interest payments on their tax returns, including the interest paid for mortgages on their primary residences, vacation homes, or commercial properties.

The role and benefits of third-party information reporting, such as Forms 1098, are central to the success of our nation's tax system because they help assure taxpayers accurately report certain deductions and income.¹ Because information reporting generally is required to take place shortly after the end of the calendar year, it provides a reliable information source taxpayers can use in preparing their annual tax returns.

***The role and benefits of
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This reduces the likelihood that taxpayers may inadvertently neglect to include items such as the mortgage interest paid on a vacation home or the interest income from a small savings account.

Besides assisting taxpayers with preparing their annual tax returns, information reporting is a key component in IRS compliance programs that are designed to detect and pursue noncompliant taxpayers who underreport income, overstate deductions, or do not file tax returns. Individuals who fail to file required returns and/or underreport their income can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. In the Information Reporting Program, IRS computers match the items reflected on the information documents submitted by third parties to the related items on the filed tax returns of those who received the documents. If the match shows a discrepancy between income reported or deductions claimed, a potential underreporter² case may be developed so the IRS can determine whether an audit is warranted to resolve these potential issues. For a match that shows no corresponding tax return, a potential nonfiler case could be initiated.

¹ There are many different types of information returns used by third parties to report income earned by taxpayers. For example, income earned from interest is reported on Interest Income (Form 1099-INT), while income earned from dividends is reported on Dividends and Distributions (Form 1099-DIV). Income from wages is reported on Wage and Tax Statement (Form W-2).

² See Appendix VI for a glossary of terms.



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As a result of this matching process, the IRS annually contacts about 3 million taxpayers regarding potential discrepancies in their tax information. Another 2 million taxpayers are contacted to resolve potential nonfiler situations.³ According to Fiscal Year 2008 IRS statistics, these contacts resulted in tax assessments of about \$6 billion against taxpayers who had filed their tax returns but underreported their income. In addition, the IRS reported making another \$10 billion in tax, penalty, and interest assessments against taxpayers who had not filed their tax returns.

This review was performed in the Small Business/Self-Employed Division and the Campus Compliance Services function in New Carrollton, Maryland, during the period January 2008 through April 2009. Except for auditing IRS databases to validate the accuracy and reliability of the information and evaluating the adequacy of IRS internal controls over Forms 1098, this audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ Average number of contacts for Fiscal Years 2004–2008 as reported in the *IRS Data Book* for each fiscal year.



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Results of Review

High Mortgage Interest Payments May Be Useful to Pursue Potential Nonfilers and Underreporters

Among the widely reported factors contributing to the high default rate in the home mortgage industry are individuals who may have assumed mortgages requiring payments that exceeded their ability to pay. We recognize that, given the current state of the economy, many individuals are struggling to meet their mortgages and other financial obligations. Nevertheless, a large number of individuals are paying a significant amount of mortgage interest and either are not filing tax returns or are filing tax returns indicating their income is not sufficient to cover their mortgage obligations and basic living expenses. The considerable difference between expenditures and income raises very serious questions about whether these taxpayers have additional sources of income that should have been reported on their tax returns.

The IRS may be able to enhance its efforts to address taxpayers who are making high mortgage interest payments, but are not filing tax returns

To its credit, the IRS recognizes the potential benefits of incorporating Forms 1098 into its compliance efforts and is using the documents in its Collection function to bring nonfilers into compliance. Under the Collection function Return Delinquency Program, nonfilers who meet specific income and mortgage interest criteria are being identified and sent notices requesting that they file their tax returns or provide explanations as to why they are not required to file. Taxpayers who are required to file, but have not done so after receiving these notices, may be sent to the Automated Collection System and/or the Collection Field function for further contact. If a taxpayer still refuses to file and the case meets the high income referral criteria, the Collection function may refer the taxpayer to the Examination function to have a “substitute” tax return prepared for them.

IRS statistics for Tax Years (TY) 2004 and 2005 combined show that Forms 1098 have been used as the basis to open cases and issue contact letters to 227,019 potential nonfilers soliciting that they file their tax returns or explain why they do not need to file. Although most (54 percent) of the potential nonfilers have yet to respond to the contact letters, statistics provided to us by the IRS indicate 69,693 delinquent returns have been received and processed. The tax assessed on 28,026 TY 2005 returns filed after nonfilers had received a delinquency notice from the IRS because of mortgage interest conditions totaled \$276 million.⁴ While the Return Delinquency Program is experiencing success in identifying potential nonfilers, our

⁴ Tax assessed on these returns processed by November 13, 2008.



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samples of Forms 1098 show the documents may also provide good audit leads for the IRS Examination function. These leads could be used with other sources of information to pursue additional potential nonfilers as well as underreporters who might otherwise not be pursued due to resource constraints.

To illustrate, we evaluated 2 statistically valid samples of 100 individuals with combined Forms 1098 totaling \$20,000 or more of mortgage interest⁵ that were filed with the IRS for TY 2005. For the first sample, we matched the taxpayer identification numbers on Forms 1098 meeting our criteria to accounts in the IRS Individual Return Transaction File and found 219,593 individuals without a corresponding tax return. From the 219,593 potential nonfilers, we randomly selected 100 for review and identified 21 individuals who appeared to have filing requirements for TY 2005, but had yet to be contacted by the IRS.

To determine the amount of taxes the 21 potential nonfilers may owe, we first followed the cash transaction analysis process used by the IRS Examination function to obtain an estimate of each individual's income. The cash transaction analysis process is an auditing technique that uses personal living expense estimates published by the Bureau of Labor Statistics in comparing a taxpayer's expenditures to their income sources. If a taxpayer's expenditures exceed their income and the source to pay for such expenditures cannot be explained, the excess represents potential unreported income.

Next, we followed the IRS procedures for preparing proposed assessments in situations where it estimates the taxes owed and prepares a "substitute" return. We found that the 21 individuals may owe as much as \$177,715 in delinquent taxes and \$107,209 in penalties and interest.⁶ When projected to the population of 219,593 potential nonfilers, our results indicate 46,115 potential nonfilers may collectively owe as much as \$625 million in delinquent taxes, penalties, and interest for TY 2005, but have not been contacted by the IRS Return Delinquency Program.⁷ The projection is based on a 95 percent confidence level. We expect the number of potential nonfilers to fall between 28,500 and 63,729 with amounts owed ranging between \$351,894,360 and \$899,456,350.

Significant underreporting may exist on tax returns filed with high mortgage interest payments

In the second sample, we matched the taxpayer identification numbers on Forms 1098 meeting our criteria to the IRS Individual Return Transaction File and identified 245,535 individuals who reported less adjusted gross income on the returns they filed for TY 2005 than the amount of mortgage interest reflected on their Forms 1098. After randomly selecting 100 of the

⁵ We chose individuals with aggregate Forms 1098 reporting \$20,000 or more of mortgage interest because it would enable us to focus our efforts on those who were more likely to have higher incomes.

⁶ Appendix V provides a detailed example of how we computed the assessments for the 21 potential nonfilers.

⁷ See Appendix IV for additional details.



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245,535 individual returns for review, we used the cash transaction analysis process and identified 37 individuals who may have underreported their income because their mortgage interest and estimated basic living expenses appear to exceed their income.

For example, we found

instance.

As Figure 1 shows, we also found significant differences between the adjusted gross incomes reported by the 37 potential underreporters and the adjusted gross incomes reported by all individuals filing tax returns for TY 2005 who had \$20,000 or more of mortgage interest.

Figure 1: Comparison Between the Adjusted Gross Incomes Reported by 37 Potential Underreporters and the Individual Filing Population

Description	Average Adjusted Gross Incomes	Average Mortgage Interest Reported
37 potential underreporters who filed tax returns for TY 2005 with \$20,000 or more of mortgage interest.	\$8,479	\$33,916
All individuals who filed tax returns for TY 2005 with \$20,000 or more of mortgage interest.	\$165,841	\$34,753

Source: Analysis of Individual Return Transaction File and Information Returns Master File data for TY 2005.

Overall, our sample results indicate the 37 potential underreporters may owe \$265,018 in additional taxes and \$61,233 in penalties and interest. When projected to our population of 245,535 individuals, our results indicate there are 90,848 potential underreporters who may owe \$801 million in additional taxes, penalties, and interest for TY 2005.⁸ The projection is based on a 95 percent confidence level. We expect the number of individuals with insufficient funds to fall between 67,501 and 114,195 with the amounts owed ranging between \$548,757,358 and \$1,053,363,428.

It is important to note that we do not know, without the IRS contacting the individuals, if the potential nonfilers identified in our review are required to file tax returns. Nor do we know, without an IRS examination, if the potential underreporters owe additional taxes, penalties, and interest. However, Examination function officials reviewed our results and agreed with our conclusions, and an outside statistician confirmed the accuracy and validity of our sampling methodologies as well as our projections. Given the potential compliance implications and

⁸ See Appendix IV for additional details.



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revenue at stake, we believe the next step is for the IRS to explore the potential opportunities that may exist for making greater use of mortgage interest data in its compliance efforts.

The IRS has a long history of using special projects to explore and evaluate new approaches to address potential areas of noncompliance. For example, some suspected areas of noncompliance within various taxpayer segments are currently evaluated and managed through various Compliance Initiative Projects within the IRS' operating divisions. With years of experience to draw upon, the IRS staff involved in these and other projects are better positioned than us to implement cost effective approaches to broadening the use of Forms 1098 in IRS compliance efforts.

Recommendation

Recommendation 1: The Director, Examination, Small Business/Self-Employed Division, should explore the feasibility of making greater use of mortgage interest data to pursue additional nonfilers and underreporters for audit.

Management's Response: IRS management agreed with our recommendation and will expand an existing Area-wide Compliance Initiative Project on the mortgage interest deduction to a Nationwide Compliance Initiative Project. IRS management will also evaluate the results and modify the Compliance Initiative Project, as appropriate, based upon the results. Further, they will form a task team to study the existing processes for identifying nonfiler workload to ensure that mortgage interest is appropriately considered in selecting nonfiler cases for delivery to examiners.



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Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to determine how effectively the IRS uses Mortgage Interest Statements (Form 1098) to identify unreported income. Unless otherwise noted, our limited tests of the reliability of data obtained from various IRS systems did not identify any material errors. We tested the reliability of the data by scanning the data received for blank, incomplete, illogical, or improper data. In addition, we traced a judgmental sample for each data set to the source IRS files to ensure accuracy. We did not perform any testing of internal controls over the systems that were the sources of our data. To accomplish this objective, we:

- I. Determined whether the IRS effectively uses mortgage interest information provided by third parties to identify individuals who are not reporting all of their income for tax purposes.
 - A. Identified what processes are in place where the IRS uses mortgage interest data to identify unreported income.
 - B. Analyzed information returns and individuals' tax records on IRS systems to determine whether there is a potential for identifying unreported income by:
 1. Identifying whether the taxpayers who had paid mortgage interest had filed tax returns and reported the mortgage interest as a deduction.
 2. Profiling and comparing the mortgage interest data on the Information Returns Master File¹ against income data on the Individual Return Transaction File to identify where there is more potential for underreporting of income.
 - a) We chose individuals with combined Forms 1098 reporting \$20,000 or more of mortgage interest because it would enable us to focus on those who were more likely to have tax return filing requirements for TY 2005. Individuals with income over \$18,400 would have to file a tax return regardless of filing status or age and, if they paid at least \$20,000 in mortgage interest, it is reasonable to assume they more than likely made at least \$18,400 in income.
 - b) We eliminated taxpayers who had filed Supplemental Income and Loss (Schedule E) with their tax returns to focus on mortgage interest on personal residences.

¹ See Appendix VI for a glossary of terms.



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3. Using the available income, mortgage interest, and other expense data to identify the amount of income reasonably needed to be able to afford the mortgage interest payments.
4. Selecting a statistically valid random sample of 100 taxpayers from a population of 245,535 taxpayers who had filed tax returns in TY 2005 with \$20,000 or more in third-party reported mortgage interest and with adjusted gross income less than mortgage interest paid, and did not file a Schedule E with their tax return. Precision, as computed based on our sample analysis using a 95 percent confidence level, is 9.51 percent.
5. Selecting a statistically valid random sample of 100 taxpayers from a population of 219,593 nonfiling taxpayers with \$20,000 or more in third-party reported mortgage interest in TY 2005. Precision, as computed based on our sample analysis using a 95 percent confidence level, is 8.02 percent.
6. Analyzing the filing and payment compliance history for both samples of taxpayers to identify (a) any tendencies towards noncompliance and unreported income and (b) whether the IRS has taken any enforcement actions on these taxpayers for TY 2005.
7. Using variable sampling techniques to quantify the potential unreported/underreported income, taxes, penalties and interest for the cases in both samples with a 95 percent confidence level.²
8. Confirming the accuracy and validity of our sampling methodologies and projections with an outside statistician.

² For the filer sample, the average adjustment was \$3,262.51 and the standard deviation was \$5,243.84. For the nonfiler sample, the average adjustment was \$2,849.25 and the standard deviation was \$6,362.61.



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Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Bryce Kisler, Audit Manager
Alan Lund, Acting Audit Manager
Craig Pelletier, Senior Auditor
Stanley Pinkston, Senior Auditor
Bob Carpenter, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Collection, Small Business/Self-Employed Division SE:S:C
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; 136,963 taxpayers owe \$1.4 billion in additional taxes, penalties, and interest (see page 3).¹ This outcome measure does not include amounts (cost) that could offset this benefit due to reallocating resources from other IRS investigations.

Methodology Used to Measure the Reported Benefit:

Outcome calculation methodology for the nonfiler² exception cases:

- We selected a statistically valid sample of 100 taxpayers from a population of 219,593 potential nonfilers that had third-party reported mortgage interest of \$20,000 or more in TY 2005.
- We identified 21 individuals who appear to have filing requirements for TY 2005, but had yet to be contacted by the IRS.
- Based on our sample error rate (21/100), we calculated the number of potential nonfilers in the total nonfiler population that appear to have filing requirements for TY 2005 and had yet to be contacted by the IRS (the projected nonfiler exception cases).
[219,593 x (21/100) = 46,115]³
- To estimate the potential amount of delinquent taxes, penalties, and interest these 21 potential nonfilers may owe, we used the Examination function's cash transaction analysis process to estimate the annual expenses and minimum income needed for each taxpayer. Based on this analysis, we estimated that these 21 nonfilers in our sample may owe \$177,715 in delinquent taxes and \$107,209 in penalties and interest.

¹ This number is rounded. The actual figure is \$1,426,735,748, which is made up of \$625,675,355 for nonfilers and \$801,060,393 for underreporters. We are 95 percent confident that the estimated total amount owed is between \$1,054,428,423 and \$1,799,043,073.

² See Appendix VI for a glossary of terms.

³ We are 95 percent confident that there are between 28,500 and 63,729 (8.02 percent precision) potential nonfilers that appear to have a filing requirement and have not been contacted by the IRS.



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Specific computations:

- Additional Taxes Due\$177,715
 - Includes Self-Employment Tax\$144,637
 - Penalties Applied\$71,666
 - Failure to File.....\$39,986
 - Failure to Pay\$26,657
 - Estimated Tax\$5,023
 - Interest.....\$35,543
 - Total Additional Taxes, Penalties, and Interest Due.....\$284,925⁴
- We calculated the average additional taxes, penalties, and interest for all 100 nonfilers in our sample. [$\$284,925/100 = \$2,849.25$]
 - We then multiplied the number of nonfilers in the total nonfiler population by the average amount due from each sample case to get the total amount of additional delinquent taxes, penalties, and interest owed by the total nonfiler population for TY 2005. [$219,593 \times \$2,849.25 = \$625,675,355$]⁵

Outcome calculation methodology for the underreporter exception cases:

- We selected a random sample of 100 taxpayers from a population of 245,535 filers that had third-party reported mortgage interest of \$20,000 or more and claimed on their TY 2005 tax returns adjusted gross income amounts less than their reported mortgage interest.⁶
- We identified 37 filers that each claimed income insufficient to cover their mortgage obligations and basic living expenses (the projected underreporter exception cases).
- Based on our sample error rate (37/100), we calculated the number of filers in the total filer population that would have claimed income that was insufficient to cover their mortgage obligations and basic living expenses. [$245,535 \times (37/100) = 90,848$]⁷

⁴ Total adjusted due to rounding to whole dollars.

⁵ Total adjusted due to rounding to whole dollars. Using the computed standard deviation of \$6,362.61 for our sample, we are 95 percent confident that the total amount owed by the projected nonfilers (exception cases) will be between \$351,894,360 and \$899,456,350.

⁶ Our data extract contained an error on 1 of 100 data segments processed (Social Security Numbers ending in "08"). Our population of 245,535 is the total records in the 99 valid data segments.

⁷ We are 95 percent confident that the number of individuals with insufficient funds to cover their mortgage obligations and basic living expenses will be between 67,501 and 114,195 (9.51 percent precision).



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- To estimate the potential amount of additional taxes, penalties, and interest these 37 filers may owe, we used the Examination function's cash transaction analysis process to estimate the annual expenses and minimum income needed for each taxpayer. Based on this analysis, we estimated that the 37 filers in our sample may owe \$265,018 in additional taxes and \$61,233 in penalties and interest.

Specific computations:

- Additional Taxes Due\$265,018
 - Includes Self-Employment Tax\$164,234
 - Penalties Applied\$8,257
 - Failure to File.....\$8,257
 - Interest.....\$52,976
 - Total Additional Taxes, Penalties, and Interest Due.....\$326,251
- We calculated the average additional taxes, penalties, and interest for all 100 underreporters in our sample. [$\$326,251/100 = \$3,262.51$]
 - We then multiplied the number of underreporters in the total underreporter population by the average amount due from each sample case to get the total amount of additional delinquent taxes, penalties, and interest owed by the total underreporter population for TY 2005. [$245,535 \times \$3,262.51 = \$801,060,393$]⁸

⁸ Using the computed standard deviation of \$5,243.84 for our sample, we are 95 percent confident that the total amount owed by the projected underreporters (exception cases) will be between \$548,757,358 and \$1,053,363,428.



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Appendix V

Example of Computing a Nonfiler Assessment

Note: *This is a hypothetical example of a potential nonfiler¹ that we are using to present additional details on how we computed the assessments for the 21 potential nonfilers discussed in the report.*

In TY 2005, an individual who did not file a tax return had third-party reported wages of \$15,000 and a bank reported that the individual paid \$25,000 in mortgage interest. We used Bureau of Labor Statistics estimates of personal living expenses for housing, utilities, transportation, health costs, and food costs to determine, based on household size,² what additional funds would be necessary to meet all expenditures.

We then used this information to compute the taxable income, taxes due, and self-employment taxes due. Since there is no record of additional wages reported for the individual, we assumed that additional income computed would be subject to self-employment tax. So, for this individual, we would have added the \$10,000 additional funds needed to pay the mortgage interest and \$18,000 to have enough money to afford the other personal living expenses. Assuming the individual is single, his or her taxable income would be \$12,822, income tax would be \$1,559, and self-employment tax would be \$3,956.

Since the 2005 tax return was not filed as of October 2008 and the individual owes taxes, he or she would also be assessed a \$1,241 failure to file penalty, an \$827 failure to pay penalty, and a \$221 estimated tax penalty. In addition, he or she would owe \$1,103 of interest on the taxes, for a total balance due of \$8,907.

¹ See Appendix VI for a glossary of terms.

² We used information from previously filed tax returns to determine the size of household if the individuals were nonfilers in TY 2005, but they had filed previously. Otherwise, we considered them to be single.



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Appendix VI

Glossary of Terms

Adjusted Gross Income – The income reported on individual tax returns after certain allowable adjustments are made from total income, such as Individual Retirement Arrangement contributions and moving expenses. It is used as a basis for various calculations, including determining the limitations on itemized deductions.

Automated Collection System – A telephone contact system through which telephone assistants collect unpaid taxes and secure delinquent tax returns from taxpayers who have not complied with previous notices.

Bureau of Labor Statistics – A Federal Government agency that researches and publishes a range of data, from inflation and consumer spending to employment, productivity and wages, and other economic measures.

Cash Transaction Analysis – An auditing technique in which a taxpayer's expenditures are compared to his or her income sources. Under this technique, if a taxpayer's expenditures exceed reported income and the source to pay for such expenditures cannot be explained, the excess represents potential unreported income.

Collection Field Function – A unit in the Small Business/Self-Employed Division field offices where IRS personnel contact taxpayers to collect delinquent accounts or secure unfiled tax returns.

Collection Function – The IRS operation that collects delinquent accounts or secures unfiled tax returns.

Compliance Initiative Project – An IRS activity that identifies and addresses areas of noncompliance within specified taxpayer groups.

Examination Function – The IRS operation that conducts audits of tax returns of individuals, partnerships, corporations, and other entities.

Individual Return Transaction File – A database the IRS maintains that contains information on the individual tax returns it receives.

Information Returns Master File – An IRS database containing all information returns transcribed or electronically received by the IRS. It contains data about both the payer and the payee from various forms, including Mortgage Interest Statements (Form 1098) and Wage and Tax Statements (Form W-2), among others.



*Mortgage Interest Data Could Be Used
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Master File – The IRS database that maintains transactions or records of individual and business tax accounts.

Nonfiler – A taxpayer who has not filed required tax returns.

Return Delinquency Program – An IRS program that identifies and addresses taxpayers who have not filed a tax return by the return due date.

Supplemental Income and Loss (Schedule E) – An attachment to a tax return that is used in reporting the income and losses from rental real estate, royalties, partnerships, and other entities.

Underreporter – A taxpayer who fails to report all of his or her income for income tax reporting purposes.



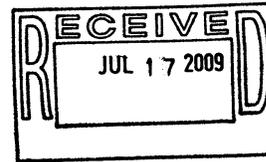
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Appendix VII

Management's Response to the Draft Report



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



July 17, 2009

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner
Commissioner, Small Business/Self Employed Division

SUBJECT: Draft Audit Report – Mortgage Interest Data Could Be Used to
Pursue More Nonfilers and Underreporters (Audit No.
200840025)

Thank you for the opportunity to review your draft report titled, "Mortgage Interest Data Could Be Used to Pursue More Nonfilers and Underreporters." We concur with your recommendation and agree that we should explore the feasibility of making greater use of mortgage interest data to pursue additional nonfilers and underreporters for audit.

We appreciate your acknowledgement of our successful use of mortgage interest data in our Return Delinquency Program and Information Reporting Program (IRP). The use of these documents may also be useful in the examination function. The IRS has a long history of using special projects to explore and evaluate new approaches to non-compliance. We also appreciate your positive comments regarding our Compliance Initiative Programs' (CIP) historical performance as a method for detecting pockets of non-compliance.

We concur with the outcome measure included in your report.

A detailed response outlining our corrective action is attached. If you have any questions, please call me at (202) 622-0600 or Monica Baker, Director, Examination, Small Business/Self-Employed Division, at (202) 283-2659.

Attachment



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Attachment

RECOMMENDATION 1:

The Director, Examination, Small Business/Self-Employed Division, should explore the feasibility of making greater use of mortgage interest data to pursue additional nonfilers and underreporters for audit.

CORRECTIVE ACTION:

1. We will expand an existing Area-wide Compliance Initiative Project (CIP) on the mortgage interest deduction to a Nationwide CIP. We will evaluate the results and modify the CIP, as appropriate, based upon the results.
2. We will form a task team to study the existing processes for identifying nonfiler workload to ensure that mortgage interest is appropriately considered in selecting nonfiler cases for delivery to examiners.

IMPLEMENTATION DATE:

1. December 15, 2011
2. December 15, 2010

RESPONSIBLE OFFICIAL:

1. Director, Examination Planning and Delivery, SB/SE
2. Director, Examination Planning and Delivery, SB/SE and Director, Examination Policy, SB/SE

CORRECTIVE ACTION MONITORING PLAN:

The Directors, Examination Planning and Delivery and Examination Policy, SB/SE will advise the Director, Examination, SB/SE of any delays in implementing these corrective actions.