



*Targeted Compliance Efforts May Reduce the  
Number of Inaccurate Information Returns  
Submitted by Government Entities*

**February 15, 2011**

**Reference Number: 2011-30-019**

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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## HIGHLIGHTS

### TARGETED COMPLIANCE EFFORTS MAY REDUCE THE NUMBER OF INACCURATE INFORMATION RETURNS SUBMITTED BY GOVERNMENT ENTITIES

## Highlights

Final Report issued on February 15, 2011

Highlights of Reference Number: 2011-30-019 to the Internal Revenue Service Commissioner for the Tax Exempt and Government Entities Division.

### IMPACT ON TAXPAYERS

The hundreds of thousands of information returns with inaccurate names and taxpayer identification numbers that are submitted annually by government entities create opportunities for individuals to underreport income and avoid the scrutiny of the Internal Revenue Service (IRS). Those individuals that take advantage of such opportunities can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system.

### WHY TIGTA DID THE AUDIT

This audit was initiated to determine the extent that government entities (Federal, State, and local) are submitting accurate information returns and whether additional steps may be needed to further enhance compliance with the reporting requirements. Accurate information reporting is central to the success of the Nation's voluntary tax system and may become even more critical after December 31, 2011, when current law requires payments by government entities for goods or services to be subject to a 3 percent income tax withholding.

### WHAT TIGTA FOUND

Government entities are more compliant in submitting information returns to the IRS with valid names and taxpayer identification numbers than the general population. Nevertheless, the IRS could not determine if \$10.2 billion of income, \$300.2 million of deductions, and \$12.6 million of tax withholdings were properly

reported in Tax Year 2007 because of inaccurate information returns submitted by government entities.

Our analysis of 794,140 inaccurate information returns found a relatively small number of government entities (75 of 85,139) were responsible for nearly one-half (48 percent) of the inaccuracies. In addition, the vast majority (86 percent) of the inaccuracies were limited to 5 types of information returns.

TIGTA recognizes it will be very difficult, if not impossible, to ensure every information return submitted contains an accurate name and taxpayer identification number. However, focusing the IRS's efforts on the small number of government entities that submit the largest portion of inaccurate information returns has the potential to deliver other benefits. Specifically, it would likely provide the IRS with additional information returns for computer matching compliance programs. This, in turn, may provide the IRS with opportunities to increase tax revenues by detecting and pursuing additional individuals who underreport income.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS expand the criteria used to select government entities for compliance activities to include the volume of information returns submitted with inaccurate names and/or taxpayer identification numbers. TIGTA also recommended that compliance activities for entities selected based on the volume of inaccurate returns not be closed until IRS personnel assess the reasons for the inaccuracies and determine any corrective actions that should be taken. To help ensure any corrective actions can be evaluated during subsequent compliance activities, the results of these assessments should be thoroughly documented within the compliance case files.

In their response to the report, IRS officials agreed with the recommendations and stated that corrective actions have been taken.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

February 15, 2011

**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 – Targeted Compliance Efforts May Reduce the  
Number of Inaccurate Information Returns Submitted by Government  
Entities (Audit # 201030005)

This report presents the results of our review to determine the extent that government entities (Federal, State, and local) are submitting accurate information returns and whether additional steps may be needed to further enhance compliance with the reporting requirements. This audit was conducted as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to Internal Revenue Service managers affected by the report recommendations. 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*

FSLG	Federal, State, and Local Governments
FY	Fiscal Year
IDRS	Integrated Data Retrieval System
I.R.C.	Internal Revenue Code
IRMF	Information Returns Master File
IRS	Internal Revenue Service
TIN	Taxpayer Identification Number
TY	Tax Year



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## *Background*

The tax gap—the difference between what taxpayers should have paid and what they actually paid on a timely basis—was an estimated \$345 billion in Tax Year (TY) 2001. One proven approach for improving tax compliance is information return reporting by third parties about items of taxpayers' income and expenses. Accurate information returns reporting encourages a high level of voluntary tax compliance because taxpayers are aware the Internal Revenue Service (IRS) has been provided the information, which reduces the likelihood that taxpayers may inadvertently neglect to include items on tax returns. In addition, information returns reporting is a key component of IRS computer matching compliance programs to verify that taxpayers properly reported income and expense items on tax returns. Through the use of information returns reporting in Fiscal Year (FY) 2007, the IRS made \$19.1 billion in additional assessments to taxpayers who underreported tax revenue or did not file tax returns.

In total, there are 45 different types of information returns received by the IRS in paper or electronic format, with the most common types being Wage and Tax Statement (Form W-2), the Form 1099 series for various income payments to payees, and the Form 1098 series for various expense payments made by payees. Among the items requiring information returns reporting per the Internal Revenue Code (I.R.C.) are many payments for items such as wages, annuities, and payments of \$600 or more for services. As a major employer and purchaser of services, governmental entities are required to fulfill the information returns reporting requirements outlined in the I.R.C.

In FY 2000, the Federal, State, and Local Governments (FSLG) office was established within the IRS Tax Exempt and Government Entities Division to serve government entities throughout the United States. The FSLG office's current customer base is approximately 105,000 government entities, including Federal and State agencies, as well as city, county, and other units of local government and quasi-governmental entities. This customer base includes entities with at least 23 million employees receiving wages in excess of \$775 billion and paying employment taxes in excess of \$200 billion, purchasing goods and services in excess of \$2.9 trillion, and holding assets valued at more than \$16 trillion. Because government entities are generally exempt from Federal income tax, FSLG office compliance efforts are focused on employment tax and information return reporting.

The FSLG office includes a Compliance and Program Management function and nine field groups. The Compliance and Program Management function develops project initiatives, updates procedures in the Internal Revenue Manual, prepares employee education and training materials, develops an outreach program for customers, handles general information requests and referrals, coordinates with the Office of Associate Chief Counsel to provide legal guidance, performs program evaluations, and conducts case selection for the field groups. The primary



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focus of the nine field groups (eight for State/local governments and one for Federal agencies) is to identify and correct noncompliance with employment tax and information returns reporting requirements. The field groups determine the appropriate audit technique for a particular case, the scope of the audit, and the most effective way to gather required information. Field groups throughout the country are also responsible for developing and delivering field education and outreach activities to the entities under their purview.

The FSLG office is currently participating in the Employment Tax National Research Program, a 3-year project designed to develop data to help identify sources of the tax gap related to employment taxes. The FSLG office has committed to examine 360 employment tax returns or 90 government entities during FY 2010 and expects the number of examinations conducted in FYs 2011 and 2012 to increase based upon experience and available resources. Due to the impact of these cases, some of which involve large government agencies, the FSLG office will limit other compliance projects during FY 2010.

Some government entities face the potential for a substantial increase in information returns reporting requirements with respect to payments beginning on or after January 1, 2012. I.R.C. Section 3402(t) generally requires the Federal Government, State governments, as well as political subdivisions and instrumentalities, to deduct and withhold 3 percent of payments made for property or services after December 31, 2011, for potential income tax liability. There are a number of statutory exceptions to I.R.C. Section 3402(t) reporting and withholding requirements, including an exception for political subdivisions of a State (or any instrumentality thereof) making payments of less than \$100 million per year for property or services. The IRS published proposed regulations on December 5, 2008, which contain a per payment threshold of \$10,000 before imposing reporting and withholding, as well as certain other exceptions. In addition, the IRS issued Notice 2010-91 providing that payment card (including credit card) transactions will not be subject to the withholding and reporting requirements of I.R.C. Section 3402(t) unless additional guidance is issued. The FSLG office made education and outreach on the application of I.R.C. Section 3402(t) a significant part of its FY 2010 outreach activities.

This review was performed at the Tax Exempt and Government Entities Division National Headquarters in Washington, D.C., during the period August 2009 through August 2010. We conducted this performance audit 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.



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## *Results of Review*

Accurate information returns reporting is central to the success of the Nation's voluntary tax system by allowing the IRS to verify that income and expense items are properly reported by taxpayers on tax returns. Information returns with invalid payee data, missing or mismatched names and Taxpayer Identification Numbers (TIN), greatly impairs the IRS's ability to conduct this verification. Given the importance of collecting the correct amount of tax revenue for governmental operations, government entities are expected to set a near perfect example of submitting information returns with accurate payee names and TINs. Although government entities as a whole are more compliant than the general population in submitting accurate information returns, additional steps by the IRS could further enhance government entity compliance with information returns reporting requirements.

### ***Government Entities Have Better Accuracy Rates Than the General Population When Submitting Information Returns***

More than 2 billion information returns were submitted to the IRS in TY 2007, of which almost 31.7 million had invalid payee data (1.5 percent).<sup>1</sup> The IRS was able to correct 1.7 million of these inaccuracies, but the remaining 29.9 million information returns with invalid payee data were unusable for computer matching compliance activity. As a whole, government entities are more compliant in submitting information returns with valid names and TINs than the general population. In TY 2007, Federal, State, and local government entities submitted almost 186 million information returns to the IRS of which almost 1.6 million had invalid payee data (0.8 percent).<sup>2</sup> The IRS was able to correct almost half of the inaccuracies from government entities, leaving 794,140 invalid information returns. As shown in Figure 1, the rate of submitting information returns with invalid payee data from TYs 2004 through 2007 is consistently lower by government entities than by the general population.

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<sup>1</sup> The total information returns submitted to the IRS in TY 2007 was 2,089,284,144, of which 31,685,299 had invalid data. The percent submitted with invalid data is 1.516 or rounded to 1.5.

<sup>2</sup> Total information returns submitted to the IRS by government entities in TY 2007 was 185,934,623, of which 1,572,890 had invalid data. The percent submitted with invalid data is 0.845 or rounded to 0.8.



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**Figure 1: Information Returns Submitted by the  
General Population and Government Entities for TYs 2004–2007**

TAX YEAR	TOTAL SUBMITTED	VALID PAYEE DATA		IRS CORRECTED PAYEE DATA		INVALID PAYEE DATA	
		Volume	%	Volume	%	Volume	%
<b>GENERAL POPULATION</b>							
2004	1,447,864,709	1,424,967,037	98.42%	510,048	0.04%	22,387,624	1.55%
2005	1,540,117,464	1,513,436,632	98.27%	1,933,833	0.13%	24,746,999	1.61%
2006	1,769,999,384	1,709,338,029	96.57%	2,218,375	0.13%	58,442,980	3.30%
2007	2,089,284,144	2,057,598,845	98.48%	1,747,703	0.08%	29,937,596	1.43%
<b>GOVERNMENT ENTITIES</b>							
2004	182,850,670	181,251,325	99.13%	751,114	0.41%	848,231	0.46%
2005	187,258,414	185,573,725	99.10%	780,971	0.42%	903,718	0.48%
2006	188,203,736	186,552,358	99.12%	813,244	0.43%	838,134	0.45%
2007	185,934,623	184,361,733	99.15%	778,750	0.42%	794,140	0.43%

Source: IRS Information Returns Master File (IRMF) Reports (#417-91-40) for the general population and our computer extracts from the IRS Business Master File<sup>3</sup> and IRS IRMF<sup>4</sup> for the government entity population.

In addition, government entities have improved the accuracy of payee data for certain information returns since a prior Government Accountability Office report. The Government Accountability Office found invalid payee data in 13 percent of vendor service payments reported on Miscellaneous Income (Form 1099-MISC) submitted by 14 Federal departments during TYs 2000 and 2001.<sup>5</sup> While analyzing TY 2007 IRMF data, we determined the inaccuracies decreased to 8 percent for Federal agencies submitting Forms 1099-MISC. The decrease is likely due to a number of actions taken by the IRS, such as the following:

- In FY 2000, establishing the FSLG office within the IRS Tax Exempt and Government Entities Division with the goal of expanding compliance efforts for government entities through compliance checks and examinations, as well as maximizing customer education through outreach events. After initial hiring, training, and identification of its customer base, the FSLG office completed 510 examinations, 36 compliance checks, and 746 outreach events during FY 2002. This increased to 1,725 examinations, 845 compliance checks, and 149 outreach events during FY 2007.
- Addressing the Government Accountability Office recommendation that the IRS and the Office of Management and Budget routinely validate all vendor names and TINs in the

<sup>3</sup> IRS database consisting of Federal tax-related transactions and accounts for businesses, including employment taxes, income taxes on businesses, and excise taxes.

<sup>4</sup> IRS database that maintains records for information returns.

<sup>5</sup> *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns* (GAO 04-74, dated December 2003).



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Central Contractor Registration<sup>6</sup> database and require all Federal agencies to use this vendor information from the Central Contractor Registration database for their Forms 1099-MISC. In October 2005, validation started for vendors to provide a name and TIN that match IRS records exactly before being eligible to bid for Federal Government contracts or apply for Federal grants. As of June 2010, there were more than 599,000 active vendors on the Central Contractor Registration database.

- In November 2003, establishing an online matching program to enable payers, including Federal agencies, to submit and receive a response if submitted payee name and TIN combinations match IRS's records. Due to disclosure laws, the IRS will not provide a payer with the correct name or TIN but provides a negative response that the payer should contact the payee for correct payee information. As of August 2009, there were more than 387,000 users registered for this online matching program and the IRS has processed more than 437.8 million requests.
- Starting in August 2003, sending Federal agencies a notice that information returns were not submitted correctly, including a list of information returns in which the payee's information was invalid. The notice also reminds the agencies of their responsibility to ensure payee information is valid and of the backup withholding requirement for payees who fail to provide the agency with correct payee information. Each year, there are notices sent to approximately 80 Federal agencies that exceed the IRS's tolerance limit for total number of inaccurate information returns submitted by an agency in a tax year.
- In September 2005, establishing a FSLG office field group dedicated to Federal agencies. In addition to compliance activities, this group is responsible for conducting annual educational seminars designed specifically for Federal agencies. The topics presented during these seminars are directly related to compliance areas such as information returns filing requirements.

Despite these measures, the hundreds of thousands of information returns with inaccurate names and TINs that are submitted annually by government entities create opportunities for individuals to underreport income and avoid the scrutiny of the IRS. Those individuals that take advantage of such opportunities can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system.

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<sup>6</sup> This is a Department of Defense database that contains vendor information. In October 2003, the Office of Management and Budget required all Federal agencies to use this database to validate vendors doing business with the Federal Government.



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***Additional Steps Are Needed to Further Enhance Government Entities  
Compliance With Submitting Accurate Information Returns***

Our analysis of inaccurate TY 2007 information returns submitted by government entities showed that nearly one-half of all governmental information returns with inaccurate payee data were concentrated in five document types submitted by a small number of government entities. By targeting its compliance activity on the small number of government entities that submit the largest portion of inaccurate information returns, the IRS could obtain hundreds of thousands of information returns for computer matching compliance programs that were not previously available. This effort will help minimize the risk that unreported tax revenue will go undetected and will create conditions for success in the future, when government entities could be required to issue millions of new information return documents.

***Inaccurate governmental information returns are concentrated in a relatively small number of entities and document types***

In TY 2007, 85,139 governmental entities submitted almost 186 million information returns to the IRS, of which 794,140 had invalid payee names or TINs that the IRS could not correct. We analyzed the 794,140 inaccurate information returns and determined 685,712 (86 percent) involved just 5 information return document types. Further, by analyzing the top 20 government entities submitting the 5 information returns with the most inaccuracies, our analysis determined a total of 75 government entities<sup>7</sup> (1/10<sup>th</sup> of 1 percent) submitted 379,664 (48 percent) inaccurate information returns. Figure 2 shows the five information document types with the most inaccuracies in TY 2007, the total number of returns submitted for each, and the number of inaccurate returns that could not be corrected by the IRS.

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<sup>7</sup> Some entities were in more than one of the top five document types and one document type only had two entities.



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**Figure 2: Analysis of Inaccurate Information Returns for Selected Document Types Submitted by Governmental Entities in TY 2007**

INFORMATION RETURN DOCUMENT TYPE	SUBMITTED	INACCURATE
<b>Tuition Statement, (Form 1098-T)</b>	<b>13,761,412</b>	<b>224,099</b>
Top 20 Government Entities	1,602,069	75,071
Remaining 1,231 Government Entities	12,159,343	149,028
<b>Miscellaneous Income, (Form 1099-MISC)</b>	<b>5,990,668</b>	<b>167,254</b>
Top 20 Government Entities	1,264,997	33,225
Remaining 61,130 Government Entities	4,725,671	134,029
<b>Certain Government Payments, (Form 1099-G)</b>	<b>55,779,585</b>	<b>142,304</b>
Top 20 Government Entities	39,608,787	122,956
Remaining 1,100 Government Entities	16,170,798	19,348
<b>Benefit Statement, (Form SSA/RRB-1099)</b>	<b>53,415,287</b>	<b>97,884</b>
Top 20 Government Entities (only 2)	53,415,287	97,884
No remaining Government Entities	0	0
<b>Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R)</b>	<b>13,736,709</b>	<b>54,171</b>
Top 20 Government Entities	9,349,900	50,528
Remaining 3,354 Government Entities	4,386,809	3,643
<b>SUBTOTAL FOR TOP 5 DOCUMENT TYPES</b>	<b>142,683,661</b>	<b>685,712</b>
Top 75 Government Entities	105,241,040	379,664
Remaining Government Entities	37,442,621	306,048
<b>ALL OTHER DOCUMENTS SUBMITTED BY GOVERNMENT ENTITIES</b>	<b>43,250,962</b>	<b>108,428</b>
<b>TOTAL DOCUMENTS SUBMITTED BY 85,139 GOVERNMENT ENTITIES</b>	<b>185,934,623</b>	<b>794,140</b>

Source: Our computer extracts from the IRS Business Master File and IRMF for the governmental entity population.

The 379,664 inaccurate information returns submitted by 75 government entities in TY 2007 resulted in \$10.2 billion in income, \$300.2 million in deductions, and \$12.6 million in tax withholding that could not be computer verified to tax returns by the IRS to determine if the payee properly reported the amounts. To better understand the potential for underreported tax revenue, we selected samples from 4 of the 5 information return documents with the most inaccuracies, as shown in Figure 2, and estimated that 26,943 taxpayers failed to properly report \$86.3 million of payments on tax returns and owe \$11.8 million in delinquent taxes. Details of the four samples reviewed are discussed in Appendix IV.

**Additional targeted contact could significantly improve the accuracy of governmental information returns**

The FSLG office interacts with its customer base using a variety of methods. Customer assistance is provided to assist individual customers with tax issues, generally following a customer request. The FSLG office also has an Annual Work Plan consisting of outreach



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activities, compliance checks, and examinations. Outreach activities, such as speeches, workshops, and newsletters are conducted across the FSLG office’s customer base to provide educational information to help customers comply with tax laws. Compliance checks and examinations are initiated for entities identified by the FSLG office during its workload selection process. Compliance checks do not include a review of the books and records of the taxpayer, but instead include a review of the tax returns and information returns filed by the entity, with the goal of educating the entity on its reporting requirements and increasing voluntary compliance. Examinations include a review of the books and records relating to the determination of the entity’s employment tax liability, as well as addressing related employment and information return issues. A compliance check can be converted into an examination if the specialist determines that significant noncompliance exists for the entity’s employment tax obligations. Figure 3 shows the number of compliance checks and examinations completed by the FSLG office during FYs 2002 through 2009.

**Figure 3: Number of Compliance Checks and Examinations  
for FYs 2002–2009**

FY	COMPLIANCE CHECKS	EXAMINATIONS
2002	36	510
2003	690	411
2004	744	1,078
2005	807	1,116
2006	914	1,818
2007	845	1,725
2008	860	2,008
2009	906	2,627

*Source: Tax Exempt and Government Entities Division’s Business Performance Reviews.*

Although the FSLG office’s compliance activity has significantly increased since FY 2002, government entities with the largest number of inaccurate information returns have not been consistently identified for compliance activity. Of the 75 government entities in our review that submitted the largest number of inaccurate information returns in TY 2007, just 39 (52 percent) were selected by the FSLG office for an examination or compliance check between February 2002 and January 2010. As of January 2010, 29 of the 39 had been closed.

One reason that government entities with the largest number of inaccurate returns have not been consistently chosen for compliance activity is that the FSLG office’s case selection criteria consider government entities that submit a high percentage of inaccurate information returns or have a repeat history of receiving information return penalties or backup withholding notices. However, the FSLG office’s case selection criteria do not consider whether the government entity submitted a high number of inaccurate information returns, regardless of the overall percentage of inaccurate returns. By focusing compliance activity on the small portion of government entities that submit the largest number of inaccurate information returns, we believe



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the IRS could obtain hundreds of thousands of information returns for computer matching compliance programs that were not previously available.

In addition, when examiners close the compliance activity before making contact with the entity, as was done in 9 of the 39 cases involving the 75 government entities in our review, the examiner loses the opportunity to offer education for any problematic situations faced by the entity in obtaining payee information. When we discussed potential reasons for inaccurate payee data with officials from 2 government entities among the 75 entities submitting the largest number of inaccurate information returns, we found that there were certain situations involving deaths and non-United States citizens that made it difficult for the government entities to obtain accurate payee information. In addition, there was confusion about tax law requirements for reporting certain payment transactions to the IRS. Closing a compliance activity before making contact with the entity prevents FLSG office examiners from addressing customer issues such as these.

Although it will be very difficult, if not impossible, to ensure that every information return submitted contains an accurate name and TIN, focusing the IRS's efforts on the small number of government entities that submit the largest portion of inaccurate information returns has the potential to deliver other benefits. Specifically, it would likely provide the IRS with additional information returns for computer matching compliance programs. This effort, in turn, may provide the IRS with opportunities to increase tax revenues by detecting and pursuing additional individuals who underreport income.

Should more focused contacts fail to significantly reduce the number of inaccuracies, the IRS may consider seeking regulatory or legislative changes to address the problem. I.R.C. Sections 6721 through 6723 authorize the IRS to assess civil penalties against payers that submit incomplete or inaccurate information returns. The potential penalty on payers is \$50 per failure to properly provide information returns up to an annual maximum of \$250,000. However, penalties are not asserted and collected against Federal Government entities because of a longstanding government policy based on a Comptroller General ruling.<sup>8</sup> Because 17 of the 75 entities with the largest number of inaccurate information returns were from the Federal Government, a Comptroller General ruling change, and possibly a legislative change, would be required to increase the effectiveness of penalties.

Another potential tool to increase the accuracy of information returns is the use of backup withholding. Backup withholding has the advantage of ensuring that some amount of tax is paid on the reported income without waiting for a valid TIN to be provided. I.R.C. Section 3406 authorizes the IRS to require payers to begin backup withholding of taxes, at the rate of 28 percent, from a payee that provides an inaccurate TIN or fails to provide a TIN. Once the IRS determines that a threshold level of invalid payee names or TINs exists for a given payer, payers should be notified to begin backup withholding. Payers are also required to begin backup

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<sup>8</sup> Comptroller General Opinion B-161457 (May 9, 1978).



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withholding if a payee fails to provide a TIN, without waiting for notification from the IRS. In TY 2007, 57 of the 75 government entities in our review were issued a backup withholding notice, although some notices were issued because of inaccuracies involving other information returns than the ones included in our review. However, not all information return documents are subject to backup withholding. Of the top five document types identified in our review, only the Form 1099-MISC falls under I.R.C. Section 3406 and is subject to backup withholding. Again, a legislative change would be necessary to require backup withholding on the other document types in our review.

### ***Recommendations***

The Director, FSLG, Tax Exempt and Government Entities Division, should:

**Recommendation 1:** Expand the criteria used to select government entities for compliance activities to include the volume of information returns submitted with inaccurate names and/or TINs.

**Management's Response:** IRS management agreed with this recommendation. The FSLG office has issued revised compliance selection criteria to add consideration of the volume of erroneous payee data in determining workload selection.

**Recommendation 2:** Revise procedures for closing compliance activities to ensure that compliance activities for entities selected based on the volume of inaccurate payee data are not closed until contact has been made with the government entity to assess the reasons for the inaccuracies and to determine any corrective actions that should be taken. The results of these assessments should be thoroughly documented within the compliance case files so any corrective actions can be evaluated during subsequent compliance activities.

**Management's Response:** IRS management agreed with this recommendation. The FSLG office has issued instructions to field staff to ensure that returns selected for review based on the volume of erroneous payee data are not closed without properly addressing the issue and to ensure that the results of these assessments are thoroughly documented in the case files.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

The overall objective was to determine the extent that government entities (Federal, State, and local) are submitting accurate information returns and whether additional steps may be needed to further enhance compliance with the reporting requirements. To accomplish our objective, we:

- I. Obtained background about the information returns process and IRS responsibilities to address government entity compliance. This included research of prior audit reports, policies, procedures, forms,<sup>1</sup> business plans, program and inventory reports, laws, regulations, and organization structure.
- II. Determined the extent that government entities and the general population submit information returns with invalid payee data, which includes missing or mismatch names and TINs.
  - A. Obtained a computer extract on August 24, 2009, from the Business Master File<sup>2</sup> for all government entities as coded by the IRS. To ensure extracted data were sufficiently reliable for our review, we scanned field elements for expected values and completeness as well as compared 20 random computer extracted records with source data using the Integrated Data Retrieval System (IDRS).<sup>3</sup>
  - B. Using data gathered in Step II.A, obtained a computer extract from the IRMF<sup>4</sup> for summary data of all information returns submitted by known government entities during TYs 2004 through 2007. This included summary counts by TY, entity, type of information return, and documents submitted including those with valid, IRS corrected, or invalid payee data. To ensure extracted data were sufficiently reliable for our review, we scanned field elements for expected values and completeness as well as summing subtotal fields to equal grand totals.
  - C. Obtained IRMF reports (#417-91-40) for summary counts of all information returns submitted during TYs 2004 through 2007. This included counts by TY, type of information return, and documents submitted including those with valid, IRS corrected, or invalid payee data.

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<sup>1</sup> This includes internal and external forms, documents, publications, letters, notices, etc.

<sup>2</sup> IRS database consisting of Federal tax-related transactions and accounts for businesses, including employment taxes, income taxes on businesses, and excise taxes.

<sup>3</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

<sup>4</sup> IRS database that maintains records for information returns.



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- III. Determined if additional steps are needed to further enhance government entities compliance with accurately submitting information returns.
- A. Analyzed the computer extract of government entity information returns obtained in Step II.B to determine the top five information return types submitted in TY 2007 with the most invalid payee data (missing or mismatch name and TIN). Also, we identified up to 20 government entities in TY 2007 with the greatest volumes for each of the top 5 information return types, which resulted in 75 government entities because some entities were in more than 1 of the top 5 information return types and 1 information return type only had 2 government entities.
  - B. Researched the 75 government entities with the most submitted invalid payee data for the top 5 information return types identified in Step III.A. to determine if an information return penalty notice was issued to the entity, if a backup withholding notice was issued to the entity, if the FSLG office conducted a compliance check or examination for the entity, and if the entity participates in the IRS eServices' TIN Matching Program.
  - C. Obtained a computer extract from the IRMF for specific TY 2007 information returns data related to the 75 government entities identified in Step III.A. This included payee names, TINs, addresses, and amounts (payment, expense, and withholding) reported by the 75 government entities for each invalid payee data submitted for the top 5 information return types. To ensure extracted data were sufficiently reliable for our review, we scanned field elements for expected values and completeness, as well as compared 20 judgmental computer extracted records for each of the top 5 information return types with source data using the IDRS.
  - D. Using the computer extract in Step III.C, quantified the total payment, expense, and withholding amounts submitted on the top 5 information return types with invalid payee data provided by the 75 government entities.
  - E. Using the computer extract in Step III.C, selected stratified variable statistical samples of invalid payee data records for four of the five information return types. Using IDRS research, we attempted to determine the correct payee name or TIN for each sample case. If successful, we conducted additional IDRS research to determine if the payee correctly reported the amount from the invalid information return on their tax return. If the amount was not correctly reported, we determined the tax effect of the misreported amount. The results were confirmed with a designated IRS technical expert. See Appendix IV for additional information regarding the selection and estimates made from these samples.
  - F. Researched the FSLG office's case selection criteria for compliance checks and examinations. Also, we discussed with FSLG office officials what controls are



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missing or ineffective to enforce accurate information returns are submitted by government entities.

**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for receiving information returns, notifying payers of possible penalties and backup withholding requirements involving invalid payee data, and identifying government entities for compliance activity. We evaluated these controls by reviewing written materials, interviewing management, and reviewing samples of information returns with invalid payee data.



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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  
Robert Jenness, Audit Manager  
Aaron Foote, Lead Auditor  
William Tran, Senior Auditor  
Ali Vaezazizi, Auditor  
Brian Hattery, 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, Tax Exempt and Government Entities Division SE:T  
Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE  
Director, Federal, State, and Local Governments, Tax Exempt and Government Entities Division  
SE:T:GE:FSL  
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, Tax Exempt and Government Entities Division SE:T



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## 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:**

- Increased Revenue – Potential; \$11,878,731 for 26,943 taxpayers; \$59,393,655 over 5 years (see page 6). The potential revenue increase is related to projected taxpayers who failed to report payments on tax returns as described in this Appendix. In making the projections, we assumed there were no legitimate reasons for the payments to be excluded from the tax returns and, therefore, would result in the assessment of the additional income taxes. We also applied 2 years of interest at the appropriate rate to reflect the approximate time period from the due date of the returns to the date of our review.

#### **Methodology Used to Measure the Report Benefit:**

To estimate the potential additional income taxes associated with four payment types related to inaccurate information returns submitted by government entities, we:

1. Obtained an August 2009 computer extract from the IRS Business Master File<sup>1</sup> of 104,954 entities coded as government entities. We conducted validation testing to determine that the information was reliable for our testing needs by scanning data field elements for reasonability (e.g., expected values, completeness, and nulls for values) and comparing random extracted records to actual data on the Business Master File using the IDRS. In addition, we compared our computer extract to a September 2009 computer list of 105,192 government entities provided by the Tax Exempt and Government Entities Division and found the differences to be immaterial.
2. Obtained an October 2009 computer extract of summarized IRMF<sup>2</sup> data for TYs 2004 through 2007 for each government entity identified in Step 1. These data included the number of submitted information returns by document type that contained accurate, corrected by the IRS, and inaccurate payee information. We conducted validation testing to determine

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<sup>1</sup> 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.

<sup>2</sup> The IRS database that maintains records for information returns.



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that the information was reliable for our testing needs by comparing subtotals with grand totals and scanning data field elements for reasonableness.

3. Analyzed the summarized IRMF data in Step 2 to determine the top five information return document types with the highest volume of inaccurate payee data submitted by government entities during TY 2007. This identified Tuition Statement (Form 1098-T), Miscellaneous Income (Form 1099-MISC), Certain Government Payments (Form 1099-G), Benefit Statement (Form SSA/RRB-1099), and Distribution From Pensions, Annuities, Retirement or Profit-Sharing Plan, IRAs, Insurance Contracts, etc. (Form 1099-R). In addition, we identified the 20 government entities with the highest volume of inaccurate payee data for each of the top 5 information return document types. This resulted in 75 unique government entities because some entities were in more than 1 of the top 5 document types and 1 document type only had 2 entities.
4. Obtained a November 2009 computer extract of detailed TY 2007 IRMF data for government entities that submitted inaccurate payee data for the top five document types identified in Step 3. These data contained payee data submitted on information returns including TINs, names, addresses, and payment information including type and amounts. We conducted validation testing to determine that the information was reliable for our testing needs by scanning data field elements for reasonableness and comparing random extracted records to actual data on the IRMF using the IDRS.
5. Selected stratified variable random samples for four payment types related to the top five information return document types and government entities identified in Steps 3 and 4. The stratification was based on the payment amount, and random cases were selected using an interval sampling technique. Using IDRS research, the sample cases were first reviewed to determine the correct payee name and/or payee TIN. If the payee name or TIN remained undetermined after research, no exception was taken. If the payee name and TIN could be determined, the appropriate tax return was checked to verify if the payment amount on the form was reported on the tax return. If not reported, a tax effect that included delinquent taxes and 2 years of interest was calculated for underreported payments of the samples based on the taxpayer's reporting situation. Exception cases were confirmed by IRS officials. Below is additional information for each of the four payment types sampled.
  - Form 1099-MISC is used to report 12 different payment types. Of the 33,225 information returns with invalid payee data submitted by the top government entities, we concentrated on the 19,377 that reported nonemployee compensation payments totaling more than \$2.1 billion. Using a stratified variable random sample of 137 inaccurate information returns, we identified 8 taxpayers who did not report \$560,222 of nonemployee compensation payments and collectively owe \$162,054 in delinquent taxes and \$16,307 of interest for a total tax effect of \$178,361.



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- Form 1099-G is used to report four different types of payments. Of the 122,956 information returns with invalid payee data submitted by the top 20 government entities, we concentrated on the 111,085 that reported State/local tax refund payments totaling more than \$80 million. Using a stratified variable random sample of 127 inaccurate information returns, we identified 8 taxpayers who did not report \$101,550 of State/local tax refund payments and collectively owe \$33,887 in delinquent taxes and \$3,343 of interest for a total tax effect of \$37,230.
  - Form 1099-R is used to report distribution payments and adjustments. Of the 50,528 information returns with invalid payee data submitted by the top 20 government entities, we concentrated on the 50,500 that reported gross distribution payments totaling more than \$473 million. Using a stratified variable random sample of 124 inaccurate information returns, we identified 13 taxpayers who did not report \$790,912 in gross distribution payments and collectively owe \$99,982 in delinquent taxes and \$9,861 of interest for a total tax effect of \$109,843.
  - Form SSA-1099 or RRB-1099 is used to report Social Security or Railroad Retirement benefits paid in the current year, repaid benefits in current or previous years, and workers' compensation offset. Of the 97,884 Forms SSA/RRB-1099 with inaccurate payee data submitted from 2 government entities, we concentrated on the 93,350 that reported benefits paid in the current year totaling more than \$456 million. Using a stratified variable random sample of 144 inaccurate information returns, we identified 21 taxpayers who did not report \$183,911 in gross benefit payments and collectively owe \$6,935 in delinquent taxes and \$684 of interest for a total tax effect of \$7,619.
6. Projected our stratified variable random sample results for the four payment types described in Step 5. Collectively, we estimate 26,943 taxpayers failed to report \$86,321,487 of payments on tax returns and owe \$11,878,731 in delinquent taxes and 2 years of interest. With help from an outside statistician and using a 2-sided confidence level at 90 percent, below is additional statistical information for each of the 4 payment projections.
- Form 1099-MISC concentrating on the 19,377 nonemployee compensation payments totaling more than \$2.1 billion. Our sample projection is 1,884  $\pm$  1,353 taxpayers (9.73 percent  $\pm$  6.98 percent error rate) failed to report \$21,022,320  $\pm$  \$17,719,377 in nonemployee compensation payments and collectively owe \$5,724,978  $\pm$  \$5,980,729 in delinquent taxes and 2 years of interest.
  - Form 1099-G concentrating on the 111,085 State/local tax refund payments totaling more than \$80 million. Our sample projection is 5,327  $\pm$  4,903 taxpayers (4.80 percent  $\pm$  4.41 percent error rate) failed to report \$4,050,727  $\pm$  \$3,360,272 in State/local tax refund payments and collectively owe \$578,234  $\pm$  \$391,391 in delinquent taxes and 2 years of interest.



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- Form 1099-R concentrating on the 50,500 gross distribution payments totaling more than \$473 million. Our sample projection is 4,080  $\pm$  3,259 taxpayers (8.08 percent  $\pm$  6.45 percent error rate) failed to report \$20,634,046  $\pm$  \$15,916,399 in gross distribution payments and collectively owe \$3,330,644  $\pm$  \$2,791,761 in delinquent taxes and 2 years of interest.
- Form SSA-1099 or RRB-1099 concentrating on the 93,350 benefits paid in the current year totaling more than \$456 million. Our sample projection is 15,652  $\pm$  6,566 taxpayers (16.77 percent  $\pm$  7.03 percent error rate) failed to report 40,614,394  $\pm$  \$23,993,404 in benefit payments and collectively owe \$2,244,875  $\pm$  \$2,493,558 in delinquent taxes and 2 years of interest.



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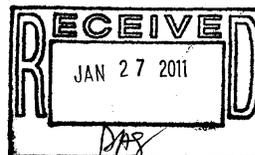
**Appendix V**

*Management's Response to the Draft Report*



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

JAN 24 2011



**MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT**

FROM:

Joseph H. Grant   
Acting Commissioner,  
Tax Exempt and Government Entities Division

SUBJECT:

Response to Draft Audit Report – Targeted Compliance Efforts May Reduce the Number of Inaccurate Information Returns Submitted by Government Entities (Audit # 201030005)

Thank you for the opportunity to review your draft report on reducing the number of inaccurate information returns submitted by government entities. We appreciate your acknowledgement of the improvements we have made to increase the use of information return data as part of our workload selection efforts.

As noted in the report, our Federal, State and Local Governments office (FSLG) was established in 2000 to address government entities in their role as taxpayers. A significant part of our compliance efforts directly relates to filing and reporting compliance for information returns.

The report identifies two recommendations to improve the FSLG information return compliance program. These recommendations address our workload selection process and the closing review process for returns selected because of erroneous payee data. We agree with your recommendations and have begun implementing them.

We concur with the estimate of the measurable benefit on tax administration that you present in your report.

Attached is a detailed response outlining our corrective actions. If you have questions, you may call me at (202) 283-2500 or Paul Marmolejo, Director, Federal, State and Local Governments at (559) 443-7601.

Attachment



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Attachment

**RECOMMENDATION 1:**

Expand the criteria used to select government entities for compliance activities to include the volume of information returns submitted with inaccurate names and/or TINs.

**CORRECTIVE ACTIONS:**

FSLG has issued revised compliance selection criteria to add consideration of the volume of erroneous payee data in determining workload selection.

**IMPLEMENTATION DATE:**

January 21, 2011

**RESPONSIBLE OFFICIAL:**

Director, Government Entities, TEGE Division

**RECOMMENDATION 2:**

Revise procedures for closing compliance activities to ensure that compliance activities for entities selected based on the volume of inaccurate payee data are not closed until contact has been made with the government entity to assess the reasons for the inaccuracies and to determine any corrective actions that should be taken. The results of these assessments should be thoroughly documented within the compliance case files so any corrective actions can be evaluated during subsequent compliance activities.

**CORRECTIVE ACTIONS:**

FSLG has issued instructions to field staff to ensure that returns selected for review based on the volume of erroneous payee data are not closed without properly addressing the issue, and to ensure that the results of these assessments are thoroughly documented in the case file.

**IMPLEMENTATION DATE:**

January 21, 2011

**RESPONSIBLE OFFICIAL:**

Director, Government Entities, TEGE Division