

GAO

Report to the Director, Office of
Management and Budget

September 1992

TAX
ADMINISTRATION

Federal Agencies
Should Report Service
Payments Made to
Corporations



147582



General Government Division

B-248097.1

September 22, 1992

The Honorable Richard G. Darman
Director, Office of Management
and Budget

Dear Mr. Darman:

Recent Internal Revenue Service (IRS) data show an alarming 20-percentage point decrease in corporate tax compliance between 1980 and 1987.¹ IRS' audits of 19,000 randomly selected small corporations (those with assets of less than \$10 million) showed that they paid only 61 percent of 1987 federal income tax owed compared to 81 percent in 1980. On the basis of this sample, IRS estimated that all small corporations underreported income by \$15 billion—a threefold drop in reporting compliance since 1980.

Even before discovering this compliance drop among small corporations, IRS had estimated that all corporations would not pay \$31 billion in 1992 federal income taxes owed. Further, we testified in March 1992 that 22 percent of 26,000 federal contractors we reviewed owed \$773 million in delinquent federal tax.² About 90 percent of these contractors were corporations.

Tax law generally does not require information reporting on payments to corporations. However, tax law requires that private and public organizations (payors) annually report certain payments (e.g., wages, interest) on information returns and send copies of the returns to IRS and the recipients of those payments. IRS studies show that information reporting on payments to individuals for services improves tax compliance.

The purpose of this report is to identify actions the Office of Management and Budget (OMB) and other federal agencies can take to improve corporate tax compliance. Appendix I discusses corporate compliance and the impact information reporting has on compliance.

¹IRS' Efforts to Ensure Corporate Tax Compliance (GAO/T-GGD-91-21, Apr. 17, 1991).

²Tax Administration: Federal Contractor Tax Delinquencies and Status of the 1992 Tax Return Filing Season (GAO/T-GGD-92-23, Mar. 17, 1992).

Congress wanted IRS to use the contract data to identify sources from which to collect contractors' delinquent taxes. As such, Congress requires agencies to report the data on a quarterly return when they first obligate funds for contracts. However, we testified on March 17, 1992, that IRS has not developed a way to use the contract data.

Federal agencies are required to file at least two types of information returns to report annual payments of \$600 or more. One of these information returns (Form 1099-MISC) reports payments made to individuals for services. As with private sector payors, agencies do not have to report payments for services from corporations. However, some payors voluntarily report such payments. Second, federal agencies should report the amount of forgiven debt for an individual or corporation on a Form 1099-G. Businesses generally do not have to report forgiven debts.

If an information return has an invalid TIN, IRS may inform a payor that an individual is subject to backup withholding, which means that the payor is to withhold 20 percent of the payments to that individual. If a payor cannot obtain the correct TIN within 30 days, the payor should start backup withholding and continue until such a TIN is obtained. In March 1992, IRS sent 488,000 backup withholding notices to payors on 1.5 million individuals. Since information reporting does not cover service payments to corporations, agencies are not required to begin backup withholding when a corporate contractor submits an invalid TIN.

In June 1991, we recommended that Congress enact legislation to require payors to inform IRS of certain payments made to corporations.⁶ Matching information returns to individual tax returns has proven to be highly cost-effective in generating billions of tax dollars. Such matching induces individuals to voluntarily report income and helps to identify those who do not. At least two IRS studies show that when payments for services were reported to IRS, individuals' compliance increased 14-percentage points and 48-percentage points, respectively.⁷

Our June 1991 testimony also indicated that similar results should occur under information reporting on corporate payments, particularly if IRS matched payments to corporate tax returns. In a September 1991 report,

⁶IRS Needs to Implement a Corporate Document Matching Program (GAO/T-GGD-91-40, June 10, 1991).

⁷IRS officials said they do not know why compliance increases differed so much. However, they said the 48-percentage point increase involved improperly classified independent contractors. The 14-percentage point increase covered various independent contractors, regardless of whether they were misclassified.

Under the second approach, agencies could report all service payments of \$600 or more made to corporations, regardless of whether a contract of more than \$25,000 has been awarded. This approach would lead to more payments being reported—which should increase voluntary compliance, particularly by small corporations—and help IRS identify those corporations that do not comply. The disadvantage would be the burden on payors to report additional information and on IRS to use it.

Given the importance of information reporting on inducing voluntary compliance, we believe more corporations would report contract payments on their tax returns. By being more compliant, these contractors would be less likely to become tax delinquent. IRS could use these information returns in audits or a computer match to identify corporations that do not report agency contract payments or file tax returns. We did not attempt to measure the specific costs and benefits of such a computer match.

If OMB requires agencies to report payments made to corporations for services, two important controls will be needed to achieve the desired increase in tax compliance and allow IRS to use the information. First, corporations' TINs must be correctly reported. Second, agencies must report the payments to IRS.

Because of IRS' concern about agencies not filing information returns that have correct TINs, IRS began a project in 1992 to improve federal compliance with information reporting. In our March 17, 1992, testimony on federal contractors who still owed taxes, we testified that for up to 77 percent of the contracts, agencies did not initially report contractors' TINs. We said IRS needed a way to ensure that TINs are correctly reported.

Our analysis of fiscal year 1990 contract awards and IRS' data showed a problem with TINs. Contractors provided valid TINs for \$20.9 billion (42 percent) of \$49.3 billion in selected service contract categories. For example, they provided valid TINs for \$14.5 billion of \$33.7 billion in awards for engineering, accounting, research management, and related services. Valid TINs were provided for \$3 billion of \$6.6 billion in awards for business services. Without valid TINs, information returns would not help contractors to comply and IRS to use the returns.

Technology similar to that used to validate credit card purchases could allow agencies to validate TINs before paying contractors. IRS is interested in this technology, which allows an agency to electronically check the

made to corporations. Rather, information reporting covers annual payments of \$600 or more made to individuals and others for services. Agencies, however, are required to report the names and TINs of corporations, as well as others, awarded contracts of more than \$25,000 to provide services and/or products.

Our analysis focused on two ways that federal agencies could file information returns on service payments to corporations. Although these approaches could generate some additional costs, they also could help corporations to comply and IRS to identify those corporations not reporting payments or filing tax returns. For information reporting to work effectively, agencies would need to validate contractors' TINs before paying them. Withholding 20 percent of contract payments from contractors that provide invalid TINs should induce contractors to provide valid ones. Further, agencies have not had sufficient controls to ensure that they filed information returns on service payments already required to be reported.

Recommendations to the Director of OMB

We recommend that the Director, OMB require agencies to

- issue information returns on payments to corporations providing services,
- validate TINs for those contractors receiving federal contracts for services before making the first payment,
- withhold 20 percent of contract payments, under the terms of the contract, to contractors providing invalid TINs until such TINs are validated, and
- have their CFO certify annually that the required information returns on payments have been issued.

Recommendation to the Commissioner of Internal Revenue

If OMB implements our recommendations, we recommend that the Commissioner of Internal Revenue actively use the information returns in IRS' enforcement programs.

Agency Comments and Our Evaluation

In a July 8, 1992, letter (see app. IIB), the Deputy Director for Management at OMB agreed to explore with IRS the costs and benefits of requiring federal agencies to issue information returns on service payments to corporations. The Deputy Director referred to various agency costs, such as reporting payments, and business costs, such as backup withholding, that our proposal would impose. Further, he said matching corporate income reported on information returns and tax returns does not appear feasible,

TINS are invalid, and (3) have their CFOs annually certify that required information returns were filed.

Objective, Scope, and Methodology

Our objective was to identify actions that OMB and other federal agencies could take to improve corporate tax compliance. We analyzed data from other GAO work on information reporting or corporate compliance. We interviewed IRS and OMB officials to identify payments that agencies should report and how agencies could report payments made to corporations. We analyzed OMB Circular A-129 on federal credit management practices, which requires agencies to report to IRS when forgiving debts.

We analyzed data that agencies sent to GSA so that we could identify contracts awarded for services. We did not verify the accuracy of GSA's database. We judgmentally selected contract categories that appeared to be for services rather than products. To identify the portion of contracts awarded to corporations, we compared TINS for businesses receiving federal contract awards with IRS' data on corporate TINS. We did our work in Washington, D.C., from December 1991 to April 1992, in accordance with generally accepted government auditing standards.

The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of this report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

contracts owed \$773 million as of July 1991. About 90 percent of these contractors were corporations.

IRS Studies Show Information Returns Increase Taxpayer Voluntary Compliance

IRS studies have shown that when taxpayers know that IRS is aware that they have received payments, they are more likely to report those payments on their tax returns. Similarly, reporting TINs has significantly increased taxpayers' voluntary compliance. For example, in 1988, Congress required taxpayers claiming the child care credit to report the child care provider's name, address, and TIN. Following this requirement, claims for the credit dropped \$1.3 billion (34 percent) from the previous year. In addition, 65 percent more individuals reported income as child care providers. IRS credited this requirement for much of the increased reporting.

Another change occurred in 1986, when Congress required taxpayers to report social security numbers of dependents age 5 and over. Tax returns for 1987, compared to those for 1986, claimed 7 million fewer dependency exemptions. IRS officials estimated this decrease in exemptions generated an additional \$2.9 billion in revenue. In 1990, Congress lowered the age of dependents to be reported to include ages 1 and older.

Similarly, a 1989 IRS study found that information reporting on payments to independent contractors increased compliance. IRS reviewed 3,331 employers, randomly selected from 5.2 million who were required to file employment tax returns for 1984. When employers did not issue an information return, workers only reported 29 percent of the payments. Compliance increased to 77 percent—48-percentage points higher—when information returns were filed. Other IRS data show that independent contractors reported only 83 percent of payments when information returns were not filed. Reporting increased to 97 percent when payors filed information returns—or 14-percentage points higher.

GAO Recommended Legislation to Require Private Sector Reporting on Payments Made to Corporations

In our June 1991 testimony, as we discussed earlier, we recommended that Congress enact legislation to require information reporting on certain payments to corporations.³ Our recommendation was based on our analysis of corporate tax returns and IRS' experience with information reporting on payments to individuals. Matching information returns to individual tax returns has proven to be highly cost-effective in generating

³GAO/T-GGD-91-40.

For example, one IRS official said IRS data for 1990 showed that federal agencies submitted 150,000 information returns that had invalid TINs for five types of information returns.⁵ In our March 1992 testimony on federal contractors with tax delinquencies, we found that agencies were not reporting contractors' correct TINs.⁶ In 40 to 77 percent of the contracts, such problems occurred.

We believe that federal agencies could use existing technology to validate TINs provided by federal contractors before making the first payment. This technology would be similar to that routinely used by stores to verify a customer's credit card number before approving the purchase. A federal agency having a contract pending could call IRS to validate the business' TIN. IRS has been testing ways to use such technology and estimated that the cost for the equipment would be less than \$250,000.

If the contractor still does not provide a valid TIN, agencies may need some other control, such as backup withholding. However, tax law applies backup withholding authority to payments subject to information reporting. As a result, this control does not cover payments to corporations or contract obligations.

Existing procurement rules require contractors to provide correct TINs and grant sufficient authority for agencies, under terms of the contract, to withhold payments from corporate contractors that do not provide correct TINs. As a result, a regulation could be established to require agencies, as a condition of the contract, to withhold 20 percent of payments until a contractor provides a valid TIN.

Better Controls Are Needed to Ensure Federal Agency Reporting Compliance

Improved corporate compliance from information reporting also may not occur if agencies do not report corporate payments to IRS. Various government reports suggest the need for better controls to ensure that agencies file required information returns. GAO and Inspector General reports have found that many federal agencies did not comply with OMB requirements to report payments to IRS. A December 1986 report by Treasury's Inspector General to the President's Council on Integrity and Efficiency indicated that 12 of 14 agencies reviewed did not file required

⁵These information returns were for miscellaneous income, dividends, patronage dividends, stock proceeds, and original issue discounts. An IRS data systems official believed that most of the 150,000 involved miscellaneous income and dividends.

⁶GAO/T-GGD-92-23.

1990 Federal Procurement Data System Service Contracts That Could Be Subject to Information Reporting

Services	Standard dollars	Industrial code
Engineering, accounting, research management, and related services	\$33,709,977	87
Business services	6,566,507	73
Miscellaneous services	3,805,299	89
Educational services	2,812,800	82
Miscellaneous repair services	789,170	76
Health services	721,297	80
Social services	482,590	83
Personal services	137,939	72
Automotive repair and parking	77,382	75
Motion pictures	74,064	78
Hotels and other lodging places	45,265	70
Legal services	29,798	81
Amusement and recreation	10,240	79
Membership organizations	4,204	86
Private holdings	3,058	88
Museums, art galleries, and gardens	627	84
Subtotal	\$49,270,217	
Other possible service categories		
Professional, administrative, and management support services	\$ 9,368,847	^a
Property maintenance or alteration	4,110,186	^a
Social services	684,203	^a
Medical services	839,680	^a
Training	911,518	^a
Other ^b	3,011,085	^a
Subtotal	\$18,925,519	^a
Total	\$68,195,736	

^aIndustrial codes are not available.

^bOther categories each total less than \$660,000 and include (1) quality control, (2) facility control, (3) equipment installation, (4) special studies, (5) technical representation, and (6) resource management.

Source: Federal Procurement Report, fiscal year 1990.

Appendix III
Comments From OMB

Further, it is not possible to project the revenue impact of your proposal. Without a live test, any revenue estimate would be conjectural, at best. It is our guess that, over the long run, the proposal would be unlikely to generate an increase in revenue without a matching program to detect unreported income. As I have pointed out, we believe this would not be feasible.

Nonetheless, your proposal does provide for two possible benefits: (1) providing the IRS with information on payments made by Federal agencies to contractors could assist in the detection of non-filers, and (2) providing the IRS such information could assist in the verification of reported income during corporate tax audits.

For this reason, we will explore with the IRS the feasibility of using the proposed information reports for detecting non-filers, assisting in corporate audits, and matching against income reported in corporate tax returns.

We appreciate the opportunity to review this report and hope that our comments will prove useful.

Sincerely,

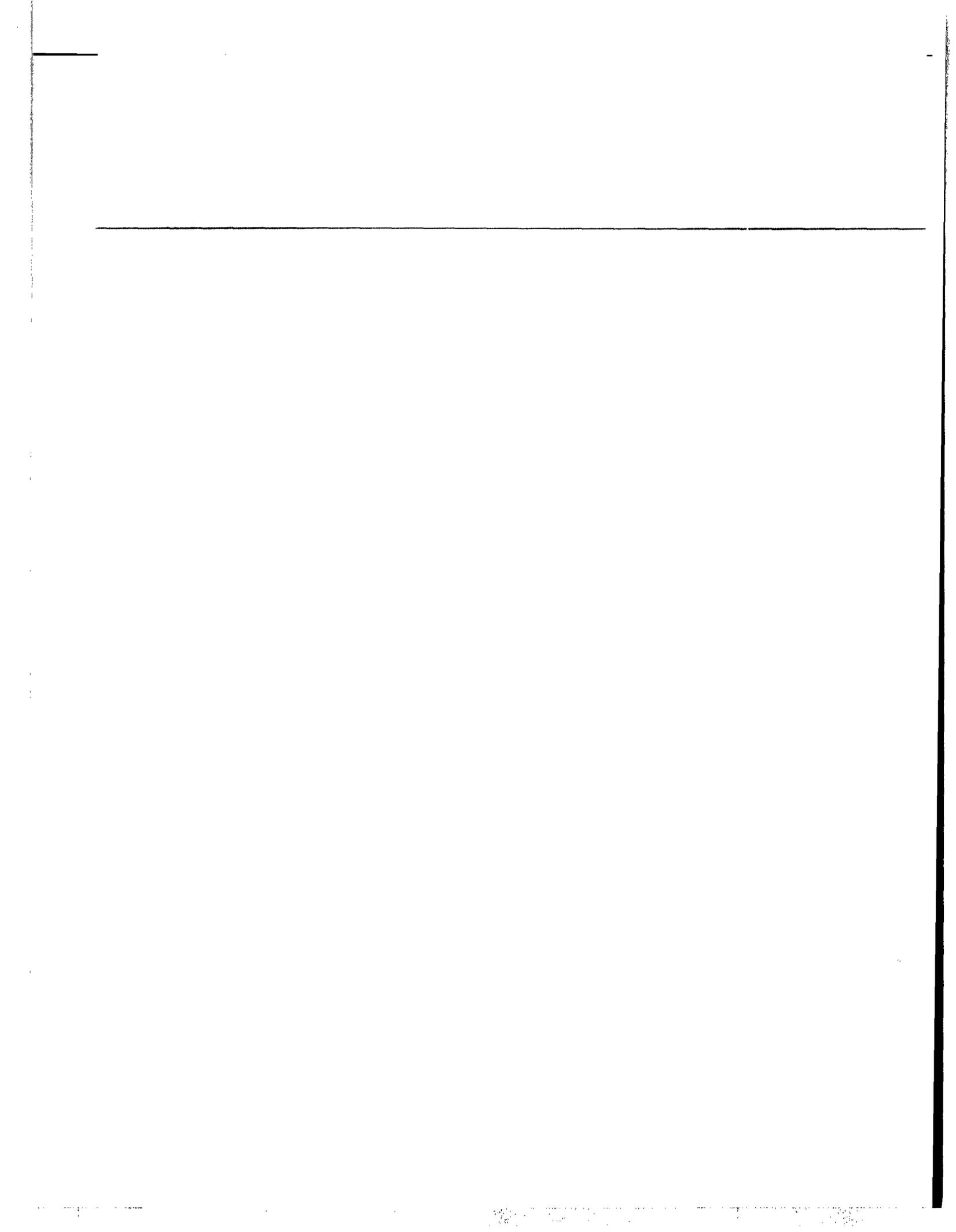


Frank Hodson

Major Contributors to This Report

General Government
Division, Washington,
D.C.

Alan M. Stapleton, Assistant Director, Tax Policy and Administration Issues
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Results in Brief

Federal agencies awarded \$68 billion for service contracts of more than \$25,000 in 1990.³ Of this amount, we estimate that \$61 billion (90 percent) went to corporations.⁴ Because information reporting generally excludes payments to corporations, agencies did not have to inform IRS of this \$61 billion.

Requiring federal agencies to report such payments could improve corporate tax compliance and provide IRS with an important tool to detect unreported income or unfiled tax returns. Given past problems in reporting payments made to individuals, agencies need controls to ensure that they report all required payments made to federal contractors, as well as the correct tax identification numbers (TIN).

Background

Tax laws require payors to provide IRS with information returns to report the names and TINs of persons receiving annual payments of \$600 or more for services, as well as the amounts received. IRS research has shown that information returns are an important tool for increasing voluntary compliance with our tax laws. When taxpayers know that IRS receives information returns on payments to them, more of these taxpayers will report this income on their tax returns. Further, IRS can match the information returns against tax returns to see whether taxpayers filed returns and reported these payments.

In addition to reporting payments, federal agencies should report the names and TINs of corporations and individuals awarded contracts for more than \$25,000.⁵ Such contracts totalled \$171 billion (90 percent) of \$191 billion in federal contracts for fiscal year 1990. This reporting of contracts differs from information reporting on service payments in at least two ways. First, the contract reporting includes the names and TINs of corporations. Second, it excludes the amounts eventually paid under the contract; as a result, IRS cannot use contract data to identify corporations that fail to report contract payments on their tax returns.

³This amount includes \$49 billion for Standard Industrial Classification Codes 70 to 89 and \$19 billion for other services (see app. II). Another \$44 billion, such as \$17 billion to operate government-owned facilities, may involve services. It is not clear whether these contracts are primarily for services that would be reported or for products that would not be reported.

⁴We based this estimate on a computer match of contractors' TINs with IRS' data on the TINs of businesses that filed tax returns.

⁵Agencies may meet this reporting requirement through the Federal Procurement Data System (FPDS), which the General Services Administration (GSA) operates. GSA forwards the data to IRS for the agency.

we identified ways to ease burdens, such as added work to track and report more payments, that could arise for payors in reporting the information and for corporations in using it.⁸ Although the success of matching information returns to corporate tax returns would depend on addressing these burdens, we believe that IRS' ongoing computer modernization will enhance its capability to develop a program to do this match. Congress is considering but has not yet acted on information reporting on corporate payments.

How Federal Agency Reporting on Corporate Payments Could Work

Agencies could report annual payments made to corporations for services using one of two approaches. The first approach builds on data that agencies already report when obligating funds for contracts that exceed \$25,000. Under this approach, agencies could identify payments that should be reported by linking obligated contract funds to actual payments of \$600 or more for services performed over the course of each year.

This linkage could be made through existing accounting systems for contract awards. For example, agencies now must send a Form 279 to GSA to report the name and TIN of a contractor for whom more than \$25,000 has been obligated.⁹ Agencies could use Form 279 as a trigger for tracking service payments made from the obligated funds during the year.

Using Form 279 in this manner should also help agencies to comply in other ways. Because Form 279 identifies whether a contract covers services or products, it would help agencies to determine the need for an information return. Otherwise, agencies' accounting systems may have difficulty distinguishing between contracts for services (which are reportable) and those for products (which are not reportable). With the information from Form 279, agencies can more easily report service payments.

This approach for reporting service payments would not eliminate the need to report the contractor's name and TIN when obligating contract funds of more than \$25,000. Congress mandated this reporting on contracts to help IRS pursue federal contractors who owe taxes. However, this approach would require agencies to issue more information returns but fewer than under the second approach.

⁸Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs (GAO/GGD-91-118, Sept. 1991).

⁹See footnote 3 on how the reporting works.

validity of a TIN. IRS could confirm the TIN or report that no such TIN existed for each contractor. If the TIN did not match, an agency could check whether it or the contractor erroneously reported the TIN. In our June 1990 report, we said IRS' Office of Chief Counsel had determined that it is not an unauthorized disclosure of taxpayer information for IRS to tell payors that no record of a particular TIN exists.¹⁰

When a corporation fails to provide the correct TIN on contract awards, tax law does not require federal agencies to withhold 20 percent of future payments until the TIN is corrected (i.e., backup withholding). However, existing procurement rules do not preclude agencies from withholding, as a condition of the contract, 20 percent of the contract payments until a contractor provides a valid TIN. With slight modifications to these rules, agencies could in fact be required to include such a provision in contracts, thereby allowing backup withholding on payments made to corporate contractors. Under such withholding, we believe that more corporate contractors would provide valid TINs.

If agencies validate TINs but do not report the payments, the increase in corporate compliance will not be realized. GAO and Inspector General reports have found that agencies often failed to report payments (see app. I). Even IRS has failed to issue information returns. A 1990 IRS report showed that IRS issued information returns on \$4 million (7 percent) of \$56 million in 1988 service payments to individuals.¹¹ If information reporting expands to corporations, a better reporting control would be needed so that agencies comply.

Agencies' Chief Financial Officers (CFO) could serve as that reporting control. CFOs oversee financial management activities in their agencies. OMB grants CFOs the authority to develop and maintain systems that produce complete and accurate financial information. Therefore, the broad scope of CFOs' authority makes them a reasonable point of control for ensuring that agencies accurately report required payments.

Conclusions

Recent IRS data indicate problems in corporate tax compliance. However, neither tax law nor current regulations generally require information reporting—which fosters voluntary compliance—for service payments

¹⁰Information Returns: Correcting Taxpayer Identification Is Possible Without Disclosing Tax Data (GAO/GGD-90-90, June 5, 1990).

¹¹Federal Agency Employment Tax Review Final Report, IRS Report (Washington, D.C.: Feb. 1990). In December 1991, IRS officials said reporting compliance had increased to 68 percent and would soon be 100 percent under ongoing initiatives.

particularly when our proposal covers a small part of all service payments made to corporations.

The Deputy Director agreed that information returns improve voluntary compliance for individuals but said that their impact on corporations is not clear. As a result, he said OMB and IRS will assess the feasibility of using information returns to detect corporate nonfilers, to improve corporate audits, and to match against income reported on corporate tax returns. Subsequent to the July 8, 1992, letter, OMB officials said such a feasibility test will be done, in conjunction with IRS, in one federal agency, and that the test results will be available in about 1 year.

In a July 2, 1992, letter (see app. IV), the Commissioner of Internal Revenue also cited the need to assess the costs and benefits of federal information reporting on service payments to corporations before she could support the concept. She said the assessment should account for how useful such information would be for IRS' matching program if only federal agencies reported it. Further, she said the study should include the costs for IRS and taxpayers to reconcile any mismatches that IRS finds between income reported on information and tax returns.

OMB and IRS expressed reluctance to match only federal agency information returns with corporate tax returns. We agree that to maximize the benefits from computer matching, information returns from both private and federal sector participants should be included in the match. That is why our June 1991 testimony recommended private sector reporting on payments made to corporations. Since we had already made that recommendation, we chose to not repeat it in this report. Rather, in keeping with the focus of this report, we recommended that IRS use federal agency information returns in its enforcement programs. Beyond any computer matches, IRS could use the information returns to identify nonfilers and assist revenue agents during corporate audits.

OMB took no position on our other three recommendations because of the decision to test corporate reporting before implementing it governmentwide. Because information reporting improves individuals' voluntary compliance, we continue to believe that OMB should implement the recommendations to improve agencies' reporting on service payments to individuals, without waiting for the test results on corporate information reporting. For such payments to individuals, OMB should require agencies to (1) validate TINs, (2) withhold 20 percent of payments if

We will send copies of this report to Congress, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others upon request. Major contributors to this report are in appendix V. If you have any questions, please call me on (202) 275-6407.

Sincerely yours,



Jennie S. Stathis
Director, Tax Policy and
Administration Issues

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Abbreviations

CFO	Chief Financial Officer
FPDS	Federal Procurement Data System
GSA	General Services Administration
IRS	Internal Revenue Service
OMB	Office of Management and Budget
TIN	taxpayer identification number

GAO Analysis of Federal Information Reporting of Corporate Service Payments

Corporate Tax Compliance Is a Problem

IRS studies have shown that corporate tax compliance is a problem. For example, the most recent IRS measurement among small corporations (i.e., less than \$10 million in assets)—using a random sample of 19,000 audited tax returns for 1987—showed that voluntary compliance had declined from 81 percent in 1980 to 61 percent in 1987—a 20-percentage point decrease. Specifically, small corporations underreported income by \$15 billion—a threefold decrease in reporting compliance since 1980. This unreported income included over \$9 billion in gross receipts earned from providing services and goods.

Even before IRS discovered this decline in tax compliance among small corporations, IRS estimated a large tax gap among all corporations. For 1992, IRS estimated that small corporations will not pay \$7 billion in federal income taxes, while large corporations will not pay \$24 billion.¹ This \$31 billion tax gap stems from corporations underreporting income and overstating deductions.

IRS measured small and large corporate tax compliance through its audits. For small corporations, IRS used Taxpayer Compliance Measurement Program audits.² However, IRS has found that audits detect only one-third of the income that taxpayers fail to report when auditors do not have information returns. As a result, the audits probably understated the unreported income among small corporations since information returns are not required on payments to corporations.

IRS has to rely on its audits of tax returns to detect unreported corporate income. However, audit coverage has been declining. In 1991, IRS audited 2.4 percent of all corporations, which is substantially less than the 6.5 percent it audited in 1980.

Another tax compliance problem involves federal contractors that do not pay taxes owed. Federal agencies are required to inform IRS of contracts of more than \$25,000 so IRS may levy agency contract payments to collect delinquent taxes. However, on March 17, 1992, we testified that IRS had not developed ways to ensure that agencies report the information or that IRS levies contract payments. A significant amount of tax dollars is involved. We found that 22 percent of the 26,000 businesses that had such federal

¹Large corporations have assets of \$10 million or more.

²These audits involve a line-by-line review of taxpayers' compliance in reporting income, deductions, and other items on their tax returns. The randomly selected small corporations in these audits had assets of less than \$10 million and represented a nationwide study universe of 2.3 million small corporate tax returns.

billions of dollars in taxes and in boosting voluntary compliance by individuals.

Recognizing start-up costs of \$70 million, we estimated that a limited document matching program on payments to small corporations for interest, rents, dividends, royalties, and capital gains would generate about \$1 billion in additional 1995 revenue. Given the growth of IRS' individual document matching program, the ratio of revenue to cost should only improve.

This 1991 testimony recognized that corporate taxpayers and payors would experience some burden and may have to change accounting and information systems. For example, information returns report payments for a calendar year, but about 60 percent of corporations file tax returns for a fiscal year. These corporations may file their tax returns for fiscal year 1992 before they receive the information returns in January 1993 for calendar year 1992. Regardless, we believe that information reporting on federal service payments will induce businesses that receive much of their income from federal contracts to voluntarily track and report the federal payments.

Another potential problem in corporate matching stems from differences in accounting for income. While information returns report payments using the cash method of accounting, 54 percent of corporations use the accrual method.⁴ However, in 1991, IRS found that this problem affected only 1 percent of the corporate income appearing on information returns but not on tax returns for 1987.

Although these and other problems can make it difficult for payors to report and for IRS to use payment information, we believe the problems can be eased by IRS working with the payors and corporations, respectively. We also believe that IRS' ongoing computer modernization will enhance IRS' capability to develop a workable matching program.

**Agencies Submitted
Incorrect TINs to IRS**

The desired increase in compliance from information reporting may not be realized if agencies do not provide the contractors' valid TINs. Because agencies do not always file information returns with valid TINs, IRS began a project in 1992 to improve reporting compliance.

⁴The accrual method of accounting recognizes income at the time it is earned (not the time it is received) and recognizes expenses at the time an obligation to pay a debt is incurred.

information returns on \$9 billion of 1984 and 1985 payments made to independent contractors.

OMB's December 1986 memorandum to the heads of federal agencies on the results of this report state that ". . . if the \$9 billion had been reported, it would have generated between \$500 million to \$600 million in additional tax revenues." OMB urged each agency head ". . . to direct your personnel, procurement, and finance staffs to work together to achieve compliance with Form 1099 reporting requirements."

More recent IRS data show that agencies—including IRS—continue to not report all payments. For example, in randomly selected cases, GSA did not report 159 of 264 payments for 1987 and 1988. A 1990 IRS report concluded that IRS reported 4 percent of \$56 million in payments in 1987 and 7 percent of \$56 million in 1988 payments.⁷ IRS' report stated that if the penalty for nonfiling applied to agencies, IRS would owe \$61,100 for these 2 years. The IRS report made 14 recommendations to improve compliance.

Our 1990 report on credit management found that the following agencies did not report forgiven debts to IRS as required: (1) Small Business Administration, (2) Veterans Affairs (Veterans Loan Guaranty Program), (3) Farmers Home Administration, and (4) Housing and Urban Development (Single and Multifamily Housing Program).⁸

⁷IRS' Federal Agency Employment Tax Review.

⁸Credit Management: Deteriorating Credit Picture Emphasizes Importance of OMB's Nine-Point Program (GAO/AFMD-90-12, Apr. 18, 1990).

Comments From OMB



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

DEPUTY DIRECTOR
FOR MANAGEMENT

July 8, 1992

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Fogel:

This letter provides our comments on the draft GAO report on "Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations" (B-248097.1), dated May 14, 1992.

Improving corporate and individual tax compliance is an Administration priority. We agree that there has been significant improvement in voluntary compliance from individual information reporting. There are, however, fundamental differences between what is needed for corporate compliance and individual compliance. It is unclear that reporting payments made by Federal agencies to corporations for services would have an effect similar to reporting income to individuals.

A program to match payments made by Federal agencies to corporations for services, as discussed in your proposal, does not appear feasible. The IRS cannot match information reports to information reported on corporate returns for the limited subset of corporate income covered by the proposal. Corporate returns do not itemize by payor. Further, calendar year, cash basis reporting for payments made to corporations would not be reconcilable against income reported by the corporation on a fiscal year, accrual basis.

Your proposal would also impose costs:

- To the Federal agencies to implement and maintain information reporting.
- To the IRS to modify its programs and procedures to permit even limited use of the information.
- To the Government as a whole to reconcile payment information reported by Federal agencies with income reported on corporate tax returns.
- To businesses subject to withholding a portion of payments pending validation of Taxpayer Identification Numbers.

Comments From IRS



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

COMMISSIONER

JUL 2 1992

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations".

Before supporting the concept of information reporting on payments for services to corporations, we believe there is a need to assess the potential benefits, costs, and burdens of federal agency reporting. Analysis of potential benefits should consider whether reporting amounts paid for services provided by corporations would provide useable information for purposes of matching payments with amounts reported on income tax returns. As you noted in your report, there is already a statutory provision which requires reporting on contracts of \$25,000 or more awarded by each Federal agency. While this information does not provide the dollar amount of payment, it does provide information that can be used by IRS in identifying businesses that should be filing tax returns and in identifying sources of income for collection purposes. Analysis of potential benefits should also consider whether it is useful for IRS to receive reporting on payments from only one source, i.e., government agencies. This information would be minimally useful for detecting unreported income, e.g., IRS could not detect underreporting as long as the corporation reported gross receipts from all sources that exceeded their income from Government contracts.

Analysis of costs and burdens should include the costs to taxpayers of reconciling information reported by Federal agencies with that reported on their returns. Taxpayers and IRS will have to reconcile mismatches that occur when payments are reported on a calendar year, cash basis and corporations report taxable income on a fiscal year, accrual basis. Such reconciliations will impose costs and burdens on both taxpayers and the Government. For these reasons, we would urge careful consideration before a decision is made to require Federal agencies to report on payments made to corporations.

Sincerely,


for Shirley D. Peterson



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