

May 2003

TAX
ADMINISTRATION

Changes to IRS's
Schedule K-1
Document Matching
Program Burdened
Compliant Taxpayers



G A O

Accountability * Integrity * Reliability

GAO
Accountability • Integrity • Reliability

Highlights

Highlights of [GAO-03-667](#), a report to the Committee on Business and Entrepreneurship, United States Senate

Why GAO Did This Study

About \$1 trillion in income was distributed in 2001 by flow-through entities such as partnerships and trusts. As shown below, these entities do not pay taxes on flow-through income. They report it to IRS on a Schedule K-1 and their partners or beneficiaries pay any tax.

Concerned about underreporting, IRS began matching the flow-through income reported on Schedule K-1s with that reported on individuals' returns. In 2002, IRS began sending notices to taxpayers about suspected noncompliance. After complaints that many notices were going to compliant taxpayers, IRS stopped sending notices.

Concerned about the burden, the committee asked GAO to, among other things, (1) describe the burden caused by the notices and IRS's rationale for stopping them, (2) assess IRS's management of the program, and (3) describe the steps IRS will take to address any problems.

What GAO Recommends

GAO is not making any recommendations, but the uncertainty about the effectiveness of the steps IRS is taking to improve the program highlight the importance of IRS continuing to monitor the impact of the program on compliant taxpayers. In ongoing work, requested by the Senate Committee on Finance, GAO is assessing the effectiveness of the program.

www.gao.gov/cgi-bin/getrpt?GAO-03-667.

To view the full report, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

INTERNAL REVENUE SERVICE

Changes to IRS's Schedule K-1 Document Matching Program Burdened Compliant Taxpayers

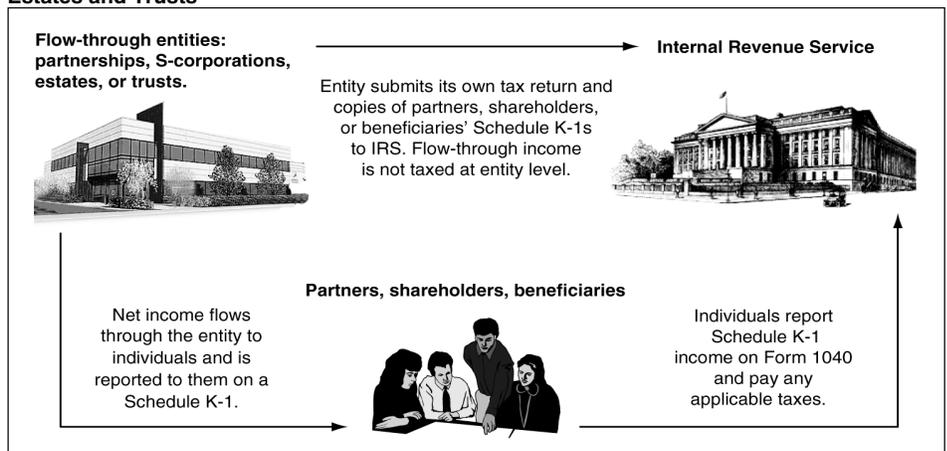
What GAO Found

IRS stopped issuing Schedule K-1 notices after complaints about the burden the program imposed on compliant taxpayers. Originally, IRS intended to focus the program on two categories of income—interest and dividends—wherein matching was straightforward, and therefore the number of notices sent to compliant taxpayers could be minimized. However IRS changed the matching program to cover additional categories of flow-through income without clearly informing taxpayers and tax preparers. Matching these additional categories of income was less straightforward. As a result, IRS sent notices about suspected noncompliance to more compliant taxpayers than it intended. In fact, about two-thirds of the notices were sent to taxpayers later determined to be compliant. After taxpayers complained, and after sending out about 70 percent of the planned notices, IRS responded by stopping the notices. IRS has assessed about \$41.4 million in additional tax from the notices that were sent and approximately \$26.9 million was directly attributable to Schedule K-1 underreporting.

IRS did not timely implement two parts of the plans for managing the Schedule K-1 matching program. First, IRS did not test the feasibility of focusing the program on interest and dividend income until after recommending such a focus and communicating the recommendation to taxpayers, preparers, and other stakeholders. Second, after changing the plan, IRS did not clearly communicate the changes.

IRS is taking steps to improve communications and reduce the burden on compliant taxpayers. However, neither IRS nor GAO knows whether these changes will improve communications and reduce burden while maintaining the effectiveness of the Schedule K-1 matching program as a compliance tool.

Illustration of the Taxation of Income That Flows Through Partnerships, S-corporation, Estates and Trusts



Source: GAO (images, Art Explosion).

Contents

Letter	1
Results In Brief	2
Background	3
Scope and Methodology	6
IRS Stopped Issuing Schedule K-1 Notices after Complaints about Burden Imposed by Program Changes	8
IRS Did Not Timely Test Its Plans or Communicate Plan Changes to Stakeholders	11
IRS Is Taking Steps Intended to Improve the Schedule K-1 Matching Program in 2003	14
Conclusion	17
Agency Comments	18

Appendix I	GAO Contact and Staff Acknowledgments	19
-------------------	--	----

Figures		
Figure 1: Illustration of the Taxation of Income That Flows through Partnerships, S-corporations, Estates and Trusts		4
Figure 2: General Underreporter Matching Process		5
Figure 3: The Number of Schedule K-1 Underreporter Notices Sent to Taxpayers		10
Figure 4: Chronology of Key Events in IRS Implementation of the Schedule K-1 Matching Program		13

This is a work of the U.S. Government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. It may contain copyrighted graphics, images or other materials. Permission from the copyright holder may be necessary should you wish to reproduce copyrighted materials separately from GAO's product.



G A O

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

May 30, 2003

The Honorable Olympia J. Snowe
Chair
Committee on Small Business and Entrepreneurship
United States Senate

Dear Madame Chair:

Approximately \$1 trillion in income was distributed for tax year 2001, according to Internal Revenue Service (IRS), by flow-through entities such as partnerships, S-corporations, estates, and trusts. These entities, many of which are small businesses, do not pay taxes on income they pass through, whether or not the income is actually distributed to their partners, shareholders, or beneficiaries. The partners, shareholders, or beneficiaries report the income or losses received on their individual tax returns and pay any applicable tax.

To facilitate compliance, the tax law requires flow-through entities to report the income passed through on Schedule K-1 and to send one copy of the schedule to IRS and another to partners, shareholders, or beneficiaries. While the law requires such reporting of flow-through income, IRS estimates that between 6 and 15 percent of such income is not reported on individuals' returns.

Because of the significant amount of income being distributed and the estimated noncompliance, IRS began in 2001 to match the tax year 2000 Schedule K-1 information provided by flow-through entities against the flow-through income reported on individuals' tax returns. IRS began notifying taxpayers of potential discrepancies between income reported on K-1 and individual tax returns in April 2002. However, after receiving complaints that notices were being sent to compliant taxpayers, IRS stopped sending notices in August 2002.

Because of concerns about the burden the Schedule K-1 matching program was imposing on compliant taxpayers, including the time and expense of responding to the notices, you asked us to review IRS's implementation of the program and determine what happened and why. Specifically, as agreed with your office, our objectives were to (1) describe the implementation of the Schedule K-1 matching program, the extent of the burden caused by the notices, IRS's rationale for stopping the notices, and

any results the program achieved, (2) assess IRS's management of the Schedule K-1 matching program, and (3) describe the steps IRS is planning to take to address any identified problems and improve Schedule K-1 reporting and matching.

To describe IRS's Schedule K-1 matching program implementation, the burden caused by the notices, IRS's rationale for suspending the program, and any results, we interviewed IRS officials and analyzed IRS data. To assess IRS's management of the program, we compared IRS's management plan to what was implemented. Finally, to describe the steps IRS plans to take to improve the program, we reviewed IRS's plans for continuing the program in 2003 and reducing the burden on compliant taxpayers.

Results In Brief

IRS stopped issuing Schedule K-1 notices after complaints about the burden imposed by program changes on compliant taxpayers. Originally, IRS intended the Schedule K-1 matching program to focus on two categories of income—interest and dividends—that are easily identified on tax returns and would minimize the number of notices sent to compliant taxpayers. However, IRS learned during testing that it could not separate underreported K-1 interest and dividend income from the other underreported interest and dividend income such as that paid by banks.

After the test, IRS expanded the Schedule K-1 matching program to cover additional categories of income, including flow-through income from trade or business activities. This created a burden for compliant taxpayers. About two-thirds of the 69,097 notices sent to taxpayers under the program were sent to taxpayers whom IRS later determined to be compliant. Compounding the problem, the expansion of the program was not clearly communicated to taxpayers or tax preparers. After complaints from taxpayers and after sending out about 70 percent of the notices intended, IRS stopped sending notices. IRS followed up on notices that were sent and has resolved about 92 percent of those cases. About 62 percent of the cases were resolved with no change to the taxpayer's liability. In the other 38 percent of the cases, an additional \$41.4 million in taxes was assessed, of which \$26.9 million was directly attributable to K-1 underreporting.

While detailed plans for managing the Schedule K-1 matching program were developed, IRS did not timely implement two parts of the plans. First, IRS did not test the feasibility of focusing the program on interest and dividend income until after recommending such a focus and communicating the recommendation to taxpayers, tax preparers, and

other stakeholders. Second, after changing the plan, IRS did not clearly communicate with taxpayers, tax preparers, and other stakeholders about the changes.

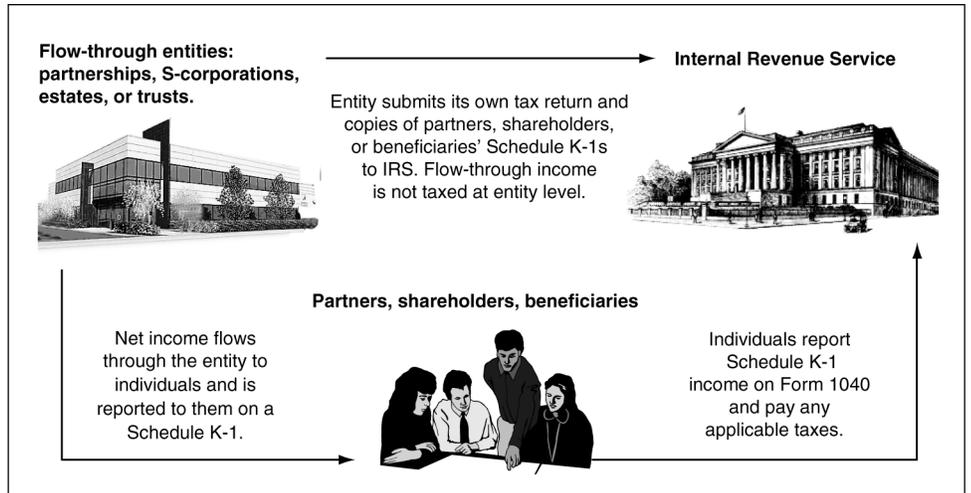
For 2003, the focus of the program will be on the same categories of income as in 2002. IRS is taking several steps intended to improve the K-1 matching program. IRS has been meeting with tax preparers and stakeholder groups in an effort to reestablish communication. Further, IRS has identified several program changes intended to reduce taxpayer burden by reducing the number of “no-change” notices sent to compliant taxpayers. Examples of these changes are more stringent screening criteria before notices can be sent and revisions to clarify forms and schedules. Neither IRS nor we know whether these changes will reduce the burden on compliant taxpayers while maintaining the effectiveness of the Schedule K-1 matching program as a compliance tool. We are not making recommendations in this report, but for the Senate Committee on Finance, we are assessing the program’s ability to detect and prevent noncompliance. IRS has a tracking system that should provide it information about the effectiveness of the changes before all the notices are sent out.

We asked IRS to provide comments on our report but did not receive a response in time to include it with this report. However, IRS officials responsible for the program told us that they agree with the facts presented in this report.

Background

Partnerships, S-corporations, trusts, and estates are collectively known as “flow-through entities,” because they have the legal capacity to pass net income or loss through to their partners, shareholders, and beneficiaries untaxed. As shown in figure 1, these flow-through entities file tax returns with IRS that report the entities’ income and expenses with schedules showing all partners’, shareholders’, or beneficiaries’ shares of net income or loss. Flow-through entities also are required to provide each partner, shareholder, or beneficiary with a Schedule K-1 stating the individual share of net income or loss to be reported. These partners, shareholders, or beneficiaries are then responsible for reporting this income or loss on their individual income tax returns and paying any tax. According to IRS in tax year 2001, over 9 million flow-through entities reported passing through \$998 billion to approximately 24 million partners, shareholders, or beneficiaries.

Figure 1: Illustration of the Taxation of Income That Flows through Partnerships, S-corporations, Estates and Trusts



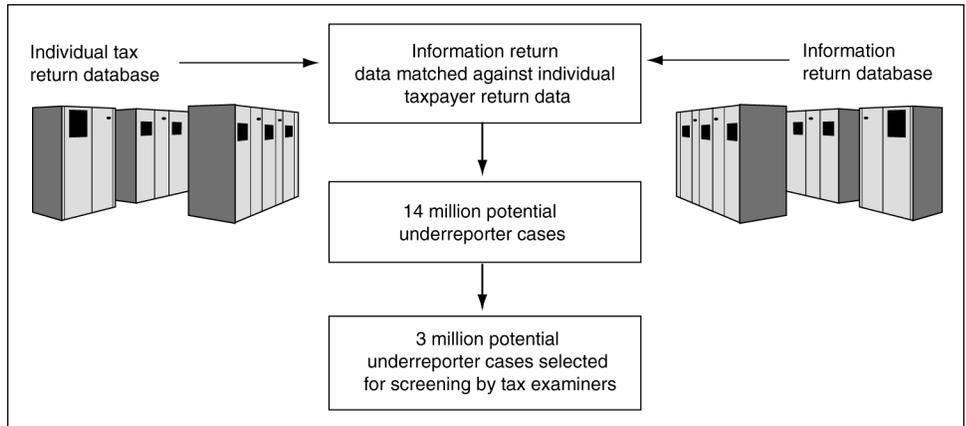
Source: GAO (images, Art Explosion).

For reporting purposes flow-through income is broken into several categories. These include income or loss from trade and business activities, rental real estate, other rental activities, interest, dividends, royalties and capital gains.

The purpose of the Schedule K-1 matching program is to compare the information provided by flow-through entities to that reported by individuals on their tax returns in order to ensure compliance. The Schedule K-1 matching program is part of IRS's general matching program, the underreporter program. As shown in figure 2, the underreporter program identifies potentially noncompliant taxpayers using information from two primary data sources:

- income reported to IRS by taxpayers on their individual tax returns and
- income reported to IRS from third parties, such as employers, banks and other financial institutions, partnerships, S-corporations, estates, and trusts on forms such as the W-2, 1099, and Schedule K-1.

Figure 2: General Underreporter Matching Process



Source: GAO.

The third party data is matched with the individual taxpayer's return data to verify that all income is reported. In fiscal year 2002, the matching process identified approximately 14 million cases where individual tax return information did not match income information reported to IRS from third party sources.

IRS does not follow up on all of these potential underreporter cases. In 2002, IRS selected 3 million of the 14 million potential underreporter cases for further review. After the cases are selected from this inventory, tax examiners perform a manual review, called "screening" of tax returns to determine if the income or deductions in question can be identified on the actual tax return. If so, the case is closed; however, if reasonable doubt remains, the taxpayer is sent an underreporter notice.¹ At this point, taxpayers can choose to agree with the additional assessment, disagree and provide reasons, or ask for an appeal.

In order for K-1 data to be used in the matching process, IRS had to input or transcribe data from K-1 information returns filed on paper into its information systems. For tax year 2000, 14.3 million paper K-1s were filed with IRS and another 5 million were filed electronically. Until it began transcription in 2001, IRS had not transcribed paper K-1 return information since 1995.

¹ The underreporter notice informs taxpayers of a proposed change to tax liability because of income that is not identifiable or apparently not fully reported on the return.

Because IRS had not transcribed Schedule K-1 information since 1995, the agency suspected noncompliance among K-1 taxpayers was significant. Based on a small study conducted in July 2000, IRS estimated that between 6 and 15 percent of the Schedule K-1 returns attached to flow-through returns are omitted from individual tax returns. Therefore, to identify the taxpayers who were potentially noncompliant and collect additional tax, IRS began planning in 2000 to (1) match Schedule K-1 income information from partnerships, etc., against income information on individual tax returns to identify potential discrepancies and (2) send underreporter notices to taxpayers suspected of noncompliance.

In 2000, Congress funded the Staffing Tax Administration for Balance and Equity (STABLE) Initiative that provided funding for transcription and matching of K-1 information. IRS told us funding provided for K-1 transcription was 378 full-time equivalent (FTE) staff, but transcription rates were higher than planned and 485 FTEs were actually expended. IRS pulled funding from other programs to cover the shortfall. The approximate cost of the K-1 transcription was about \$20 million. STABLE also included 69 FTEs and about \$3 million for screening of matched K-1 cases.

IRS had two primary goals for the K-1 matching program. The first goal was to increase voluntary reporting of flow-through income by taxpayers. Although the program will bring in some revenue directly from notices sent to taxpayers who underreported, IRS believes that the indirect effect on voluntary reporting could be more important. IRS believes that the knowledge that K-1s are being matched will have a positive impact on self-reporting of flow-through income.

IRS's other primary goal was to target K-1 related underreporter notices on noncompliant taxpayers to the extent possible. Responding to notices is burdensome for compliant taxpayers. Taxpayers and preparers are required to collect, organize, and submit information to IRS either by telephone or in writing to explain any discrepancy cited in the notice. Resolving notices sent to compliant taxpayers also forces IRS to divert scarce enforcement staff away from noncompliant taxpayers.

Scope and Methodology

In order to describe IRS's implementation of its Schedule K-1 matching program, reasons for suspending the issuance of notices, impact/burden on taxpayers, and results of the program, we:

-
- reviewed and analyzed IRS management plans, risk assessments, and other discussions of how the matching program would operate, including work group meeting minutes;
 - interviewed IRS officials regarding the efforts required to plan and implement the program, including preliminary program testing, early plans for the program, changes made in program plans, problems with stakeholder communication, and the suspension of notices related to Schedule K-1 income;
 - reviewed documents issued by external parties regarding concerns with the Schedule K-1 matching program;
 - interviewed stakeholders from outside IRS, including enrolled agents and members of professional organizations, IRS advisory committees; and
 - reviewed data and statistics resulting from the Schedule K-1 matching program, including number of taxpayers sent notices and tax revenue assessed.

We assessed IRS's management of the Schedule K-1 matching program by reviewing the plans and risk assessment developed by IRS and then comparing IRS's implementation of the program to these plans.

To describe the steps IRS is taking to reduce burden and improve the matching program, we:

- interviewed IRS officials regarding the changes being implemented for continuation of the Schedule K-1 matching program, including changes to reduce taxpayer burden;
- reviewed external stakeholder documents that offered suggestions for the future of the Schedule K-1 matching program;
- interviewed stakeholders from outside IRS regarding their suggestions for the Schedule K-1 matching program;
- observed a public meeting of the Information Reporting Program Advisory Committee (IRPAC); and
- observed a working group session of IRS and external program stakeholders.

The underreporter data presented in this report was produced by IRS, and we did not independently verify its accuracy. However, we have used underreporter program data in past reports and have found underreporter summary statistics of the type used in this report to be reasonably accurate. We performed our work from June 2002 through May 2003 in accordance with generally accepted government auditing standards.

IRS Stopped Issuing Schedule K-1 Notices after Complaints about Burden Imposed by Program Changes

In its original plan for the Schedule K-1 matching program, IRS intended to focus on two categories of income: interest and dividends. IRS officials believed that such a focus would enable IRS to minimize the number of notices sent to compliant taxpayers. However, information system limitations, along with a desire to direct resources towards K-1 underreporter cases, caused IRS to expand this focus and include more categories of income in the program. This change was not clearly communicated to taxpayers or preparers and led to more compliant taxpayers receiving underreporter notices. In the face of complaints about the burden imposed on compliant taxpayers, IRS stopped sending K-1 underreporter notices.

The Types of Income Covered by the Schedule K-1 Matching Program Changed from IRS's Original Plan

Originally, IRS planned the Schedule K-1 matching program to focus on two categories of flow-through income: interest and dividends. The plan called for identifying underreporter cases with discrepancies between interest and dividend income reported on a K-1 and what was reported on an individual's tax return.² Notices would then be sent to the taxpayers asking them to explain the discrepancies or pay the additional tax.

IRS chose to focus the Schedule K-1 matching program on interest and dividend income to minimize the chances of compliant taxpayers receiving notices about K-1 discrepancies. IRS based its decision on a risk matrix that summarized the risk of sending a notice to a compliant taxpayer for the various categories of flow-through income. Interest and dividend income were identified as low risk because they are easily identified on individuals' tax returns. Short and long-term capital gains and royalties were considered a moderate risk because the K-1 information was less likely to be accurate or the income could be harder to locate on individuals' returns. Income from trade or business activities, rental real estate, other rental activities, and guaranteed payments was considered high risk because it could be much harder to isolate on individuals' returns. For example, some taxpayers would reduce or net their flow-through income in these four categories by subtracting carryover losses or expenses. Although IRS's tax form instructions caution against such

² While the K-1 matching program was designed to select the underreporter cases with discrepancies in interest and dividend income reported on the K-1s, a small sample of cases with other types of K-1 income was also to be included.

netting, some taxpayers still do so, which can make flow-through income appear to be underreported.

Starting in 2001, IRS began briefing representatives from stakeholder groups on its plan for the Schedule K-1 matching program. IRS met with two of its advisory committees, composed primarily of tax practitioners, the Internal Revenue Service Advisory Committee (IRSAC) and the Information Reporting Program Advisory Committee (IRPAC), and other practitioner groups. During these discussions with stakeholders, IRS informed them that underreported K-1 interest and dividend income would be the focus of the K-1 matching program.

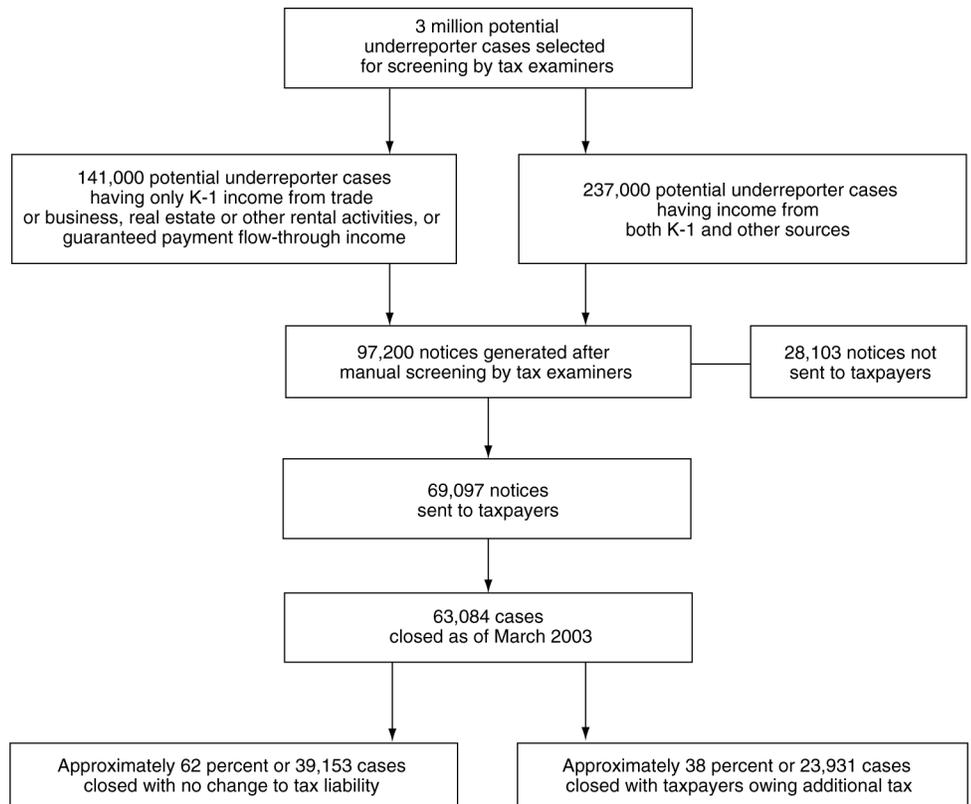
In October of 2001, IRS discovered during testing that the underreporter computer system could not distinguish underreported K-1 interest and dividend income from other interest and dividend income reported on information returns such as Form 1099s. Because of a desire to direct the 69 FTEs allocated for screening K-1 underreporter cases to K-1 cases, IRS decided to expand the focus of the K-1 matching program. IRS officials told us they had wanted to direct the resources to K-1 cases exclusively in order to be able to determine the results achieved with those resources. The revised program included flow-through income from trade or business activities, rental real estate, other rental activities, and guaranteed payments. These four categories contained K-1 reported income exclusively. As will be discussed in more detail later, IRS did not clearly communicate the change to taxpayers, tax preparers, and other stakeholders.

Under the revised matching program, IRS selected for screening by the 69 dedicated FTEs a total of 141,000 underreporter cases that appeared to have only underreported K-1 income from the four categories as shown in figure 3. In addition IRS selected another 237,000 cases that appeared to have both underreported K-1 income and underreported income from other sources. After manual screening, IRS determined that 97,200 cases raised sufficient questions about the accuracy of the amount reported on the individual tax returns to merit sending a notice of the potential discrepancy to the taxpayers. IRS began sending notices about the discrepancies to taxpayers in April 2002.

The Revised Schedule K-1 Matching Program Burdened More Compliant Taxpayers Than Originally Intended

Because of the change in focus of the program, more compliant taxpayers received underreporter notices than IRS had originally intended. As shown in figure 3, of the over 63,000 cases closed through March 2003, about 62 percent or 39,153 were closed with no change to the tax liability. The compliant taxpayers or their preparers who responded to the notices were required to submit information to IRS in writing or via telephone that explained how they reported the flow-through income on their tax return.

Figure 3: The Number of Schedule K-1 Underreporter Notices Sent to Taxpayers



Source: GAO.

Some of these compliant taxpayers were burdened because they improperly reported net amounts on their returns. As discussed previously, IRS instructions tell taxpayers to list K-1 income without netting. Nevertheless, according to IRS, many taxpayers reported net amounts, making it appear that they had underreported. After the discrepancies were explained to IRS, about 62 percent of the notices resulted in no change in the tax liability.

Because of Taxpayer Complaints, IRS Stopped Sending Schedule K-1 Underreporter Notices

Taxpayers, tax preparers, and various external stakeholder groups complained about the notices for two reasons. First, as discussed previously, the notices imposed a burden on compliant taxpayers. Though some of these taxpayers may have improperly reported net amounts on their returns, the taxpayers argued that they had been filling out their returns this way for years without incident. Second, they were not expecting underreporter notices related to flow-through income about trade or business activities, rental real estate, other rental activities, and guaranteed payments.

IRS responded by stopping the K-1 matching program notices as of August 1, 2002. As shown in figure 3, IRS sent 69,097 notices to taxpayers before that date.

IRS Followed Up on Schedule K-1 Program Notices Sent to Taxpayers

As of March 2003, IRS data shows that nearly 92 percent or 63,084 of the Schedule K-1 notices issued were closed, or resolved to IRS's satisfaction, as shown in figure 3. In nearly 38 percent or 23,931 of the closed cases, taxpayers agreed that the notices were correct, that the Schedule K-1 income was misreported, and that they owed more taxes. These cases resulted in about \$41.4 million of additional taxes assessed of which \$26.9 million related exclusively to Schedule K-1 income. IRS estimates that about 90 percent of the assessed tax will be collected.

In addition to the revenue resulting directly from the notices, IRS expects that K-1 matching will have a psychological impact on taxpayers, encouraging voluntary compliance. IRS did not have data at the time the program was being planned to allow it to estimate the likely impact on voluntary compliance. Nor does IRS have any data on the actual impact on voluntary compliance. IRS did project that a one percent improvement in K-1 reporting levels would result in approximately \$1.7 billion in additional tax reported.

IRS Did Not Timely Test Its Plans or Communicate Plan Changes to Stakeholders

IRS developed a plan for the Schedule K-1 matching program that, according to IRS, relied on established project management principles. However, IRS did not timely implement two parts of the plan. First, IRS did not test the feasibility of focusing the program on interest and dividend income until after recommending such a focus and communicating the recommendation to taxpayers, tax preparers, and other stakeholders. Second, after changing the plan, IRS did not clearly communicate with taxpayers, tax preparers or other stakeholders about the changes. Failure

to timely implement these two parts of the plan led to compliant taxpayers being surprised and burdened by the notices they received and ultimately resulted in IRS halting the Schedule K-1 notification process before all 97,200 notices were sent to taxpayers.

IRS Developed Plans for Testing and Communicating about the Schedule K-1 Matching Program

In planning the Schedule K-1 matching program, IRS officials said they relied on established principles from its Enterprise Life Cycle (ELC) project management approach, the same strategy IRS has used for planning and implementing its ongoing information systems modernization efforts. IRS developed a series of K-1 matching program management plans including those covering transcription and compliance management, risk management, and internal and external stakeholder communications. The K-1 compliance management plan called for performing two tests before selecting cases for the K-1 matching program. The first test was of underreporter program procedures and was intended to determine needs such as computer system and training updates in order to accommodate Schedule K-1 data. The second test was a review of underreporter program processes more generally. The K-1 communication plan called for communicating with internal and external stakeholders about the project status in order to address questions and concerns and manage expectations.

IRS Did Not Test the Schedule K-1 Case Selection Process before Recommending It

IRS did not test whether its original case selection process, focused on interest and dividend income, was feasible before recommending it. As shown in figure 4, IRS began planning the Schedule K-1 matching program in January 2001. As previously discussed, in July 2001, IRS recommended selecting for review by tax examiners all underreporter cases with K-1 interest and dividend income. An IRS official told us that internal discussions led IRS to believe that this was possible—that the underreporter computer system could distinguish cases with interest and dividend income reported on K-1s from that reported on other information returns. Consequently, the feasibility of focusing the K-1 program on interest and dividend income was not tested before the recommendation was made.

Figure 4: Chronology of Key Events in IRS Implementation of the Schedule K-1 Matching Program

January 2001	July 2001	October 2001	April 2002	August 2002
IRS begins planning K-1 matching program.	IRS recommends focusing the program on underreported interest and dividend income.	After testing, IRS decides to expand the program to include K-1 income from trade or business, real estate or other rental activities, or guaranteed payments.	In response to notices, taxpayers, tax preparers, and stakeholders complained to IRS about undue burden on compliant taxpayers.	IRS stops sending K-1 related notices to taxpayers.

IRS begins issuing the bulk of notices to taxpayers who have potentially underreported their Schedule K-1 income.

Source: GAO.

The second test in IRS's plan was conducted in October 2001³ and revealed that system limitations would prevent IRS from focusing the K-1 program on interest and dividend income. IRS discovered that the underreporter computer system could not distinguish K-1 interest and dividend income from interest and dividend income reported on other information returns such as Form 1099s. As a result, the focus of the Schedule K-1 matching program was changed. As discussed earlier, the revised program covered underreported trade or business, rental real estate, other rental activity, and guaranteed payment flow-through income.

IRS Did Not Communicate Matching Program Changes to Taxpayers and External Stakeholders

Although the program communication plan called for communicating with internal and external stakeholders, IRS failed to inform taxpayers, tax preparers, and other stakeholders of the changes it made to the matching program and the potential for the changes to increase burden on compliant taxpayers. An IRS official responsible for the K-1 program stated that a communication breakdown resulted in mixed messages being shared with stakeholders about the type of cases that would be selected for the K-1 matching program. IRS officials were unable to show us any documentation in which they communicated the changes to the plan. An

³ During the Case Preview, information return documents are sampled to test the quality of the information and to identify potential problems with the underreporter system.

IRSAC member told us they only became aware of the change to the program after taxpayers began receiving notices.

Tax preparers and stakeholders were critical of the fact that IRS failed to inform them of the changes made in the Schedule K-1 matching program and the effect those changes would have on compliant taxpayers. They believed compliant taxpayers were unfairly burdened by having to respond to K-1 notices since, according to an IRSAC member, preparers had not been required to submit any explanatory documents with their tax returns in the past.

IRS Is Taking Steps Intended to Improve the Schedule K-1 Matching Program in 2003

As was the case with the revised Schedule K-1 matching program in 2002, for 2003, interest and dividend income reported on K-1s will be included in the underreporter program; however, the 69 FTEs devoted to K-1 matching will again focus on the four flow-through income categories including income from trade or business activities, rental real estate, other rental activities, and guaranteed payments. As of April 2003, IRS has started issuing notices related to discrepancies in tax year 2001. Also this year, IRS is taking steps intended to reestablish communication with external stakeholders and reducing the burden on compliant taxpayers. At this time, the effectiveness of these steps is unknown.

IRS Is Working to Reestablish Communications with External Stakeholders

For 2003, the Schedule K-1 matching program will have the same focus as the revised program in 2002. Therefore, during the 2003 Schedule K-1 matching effort, it is no longer necessary for IRS to test this case selection approach in the underreporter system.

IRS is working to reestablish clear communications with external stakeholders. Since notices were stopped in August 2002, IRS has kept external stakeholders informed of program developments and held meetings with these stakeholders to consider a number of suggestions for improving the Schedule K-1 matching program. For example, in the 2 months following the notice stoppage, IRS briefed both IRSAC and its own Oversight Board on reasons for notice suspension, data collected, and plans for continuing the program with external stakeholder input.

IRS also held public meetings with IRSAC in October 2002 and IRPAC in November 2002 during which it obtained the committees' comments and suggestions for the Schedule K-1 matching program. In addition, IRS held a meeting in December 2002 with representatives of various practitioner and other stakeholder groups to discuss various aspects of the program. In this

meeting, IRS presented results of the case studies it conducted after suspension of the notices and solicited from the stakeholders ideas for improving the program in the areas of forms, matching, education and outreach, tax preparation software, and legislative changes.

IRS Is Taking Other Steps Intended to Reduce Taxpayer Burden

At least in part as a result of the stakeholder meetings discussed above, IRS has begun implementing steps intended to improve Schedule K-1 matching and clarify reporting requirements. IRS has adopted a new goal of eliminating as many no-change notices as possible and increasing the overall effectiveness of the Schedule K-1 matching program. IRS's strategy for reducing no-change notices relies on more rigorous screening of cases by examiners before notices are sent. IRS estimates that the program changes discussed below should reduce the number of no-change notices by about 50 percent from the 2002 levels. At this time, IRS does not have an estimate of the number of notices to be sent out or of what it expects the no-change rate to be.

For 2003, IRS has adopted a revised set of standards for screening cases for review in its Schedule K-1 matching program, with the intent of minimizing taxpayer burden by reducing the number of no-change notices sent. In particular, IRS will issue notices to taxpayers if K-1 income information is completely missing from a return. Also, if a taxpayer received a notice in 2002 for tax year 2000 K-1 items and agreed with the changes proposed by that notice, the taxpayer will receive a notice for any underreported K-1 income identified this year in the tax year 2001 return. If income appears underreported for a taxpayer who received a notice that resulted in a no-change last year, that taxpayer will not receive a notice this year, with the possible exception of particularly large discrepancies. In addition, if a taxpayer received no notice last year or received a notice that contained no K-1 items, this taxpayer will be sent a notice if a large discrepancy is identified. The revised screening standards will be applied to all K-1 flow-through income discrepancies.

IRS is also trying to educate taxpayers and practitioners about the proper way of reporting flow-through income, carryover losses, and deductions in order to reduce the need to send notices to compliant taxpayers about apparent mismatches. For example, in March 2003, IRS issued a news release that provided tips and reminders for K-1 filing. These tips covered topics such as proper reporting of Schedule K-1 income on individual returns, avoiding netting of income and expenses, reporting losses carried forward, and steps for reporting income when the Schedule K-1 has not yet been received.

Also in March 2003, an IRS official participated in a webcast program geared to the practitioner community to discuss requirements of Schedule K-1 reporting and field questions from practitioners. In addition, the agency will present sessions on how to report flow-through items at each of its tax forums during the summer of 2003. The agency also seeks to further educate taxpayers through outreach programs to be run by the Taxpayer Education and Communication unit, a part of IRS's Small Business/Self-Employed operating division.

Further, IRS is changing certain forms and/or schedules in order to make reporting compliance easier for the taxpayer. In a report issued March 2003, the Treasury Inspector General for Tax Administration (TIGTA) stated the lack of detailed information reported by taxpayers and/or practitioners may have been a significant reason for the number of K-1-related notices that were sent. TIGTA then recommended that IRS revise Form 1040 Schedule E to classify and report flow-through income in a manner that would allow an easier comparison with Schedule K-1. In response, an IRS official has stated that, for the 2003 filing season, the agency would issue a revised Form 1040 Schedule E that would alert practitioners to pay special attention to the written instructions on the reporting of certain losses and expenses. The desired effect of this change is to make taxpayers less likely to improperly net income and expenses being reported on Schedule E.

Finally, an IRS task force is studying the possibility of simplifying the Schedule K-1 and its instructions for different tax situations. The intent would be to reduce both pre- and postfiling burden. However, the analysis needed for the form redesign will likely not be completed until mid-2003, and it would take about 2 years total for the redesign to actually be implemented.

By fiscal year 2005, through the outreach efforts and Form 1040 Schedule E revisions discussed in the previous paragraphs, IRS believes that it can eliminate the need for the special screening procedures instituted this year. In addition to the outreach efforts and form changes mentioned above, IRS has also discussed other efforts that could be used to help make the program more automated, such as working with software vendors to make any necessary changes to electronic tax preparation programs.

While IRS intends that these changes will reduce the number of no-change notices regarding flow-through income, at this time the effectiveness of the changes is unknown. More specifically, it is not known how ambitious

IRS's goal to reduce notices sent to compliant taxpayers by at least 50 percent is nor is it known whether IRS can reduce notices sent to compliant taxpayers while maintaining the ability to act against noncompliant taxpayers.

For the K-1 matching notices being sent in 2003, IRS will be able to track the number closed with no-change through tracking reports issued every 2 weeks. These tracking reports also contain the number of notices with an assessment that the taxpayer agreed to, unreported income identified through notices, and additional taxes assessed through the notices. The reports, which IRS has begun preparing for its tax year 2001 K-1 data match, are prepared for IRS management. Officials told us that they would also be made available to outside stakeholders.

The tracking reports should give IRS management information before all notices are sent out about the effectiveness of the changes made to the program. With respect to the overall effectiveness of the K-1 matching program, one IRS official told us that he sees the level of voluntary compliance with K-1 reporting requirements as a key measure of the program's effectiveness. This official also told us that IRS plans to annually review the number of K-1 returns filed to determine if more K-1 income is being reported. He said that more reporting of K-1 income could be seen as a measure of program effectiveness. Our ongoing work for the Senate Committee on Finance will assess IRS's efforts to detect and address noncompliance by taxpayers receiving flow-through income.

Conclusion

Better targeting the Schedule K-1 matching program notices on noncompliant taxpayers matters for two reasons. Sending underreporter notices to compliant taxpayers wastes taxpayers' time and money. Similarly, IRS's scarce enforcement resources are wasted to the extent they are used to resolve notices sent to compliant taxpayers.

While no compliance program can perfectly target noncompliant taxpayers, IRS's goal of reducing the number of Schedule K-1 matching program underreporter notices sent to compliant taxpayers is laudable. However, at this time, no one—neither IRS nor external stakeholders—knows how effective IRS's proposed actions will be. Consequently, IRS's tracking of the no-change rate is very important, both for internal management and congressional oversight. Because IRS has begun tracking the no-change rate every 2 weeks, we are not making recommendations in this report. As noted earlier, we will be looking at opportunities to

improve the overall effectiveness of the Schedule K-1 matching program in our ongoing work for the Senate Committee on Finance.

Agency Comments

We asked IRS to provide comments on a draft of our report but did not receive a response in time to include it with this report. However, IRS officials responsible for the program told us that they agree with the facts presented in this report.

As arranged with your office, we will not distribute this report until 30 days from its issue date unless you publicly announce its contents earlier. After that period, we will send copies to the Chairman and Ranking Minority Member, House Committee on Ways and Means; Chairman and Ranking Minority Member, House Subcommittee on Oversight, House Committee on Ways and Means; Chairman and Ranking Minority Member, House Committee on Small Business; Chairman and Ranking Minority Member, Senate Committee on Finance; and the Ranking Minority Member, Senate Committee on Small Business and Entrepreneurship. We will also send copies to Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will make copies available to others on request. In addition, the report will be available on the GAO web site at <http://www.gao.gov>.

If you have any questions, please contact me at (202) 512-9110. Key contributors to this report are acknowledged in appendix I.

Sincerely yours,



James R. White
Director, Tax Issues

Appendix I: GAO Contact and Staff Acknowledgments

GAO Contacts

James R. White, (202) 512-9110

Staff Acknowledgments

In addition to the contact above, Marvin McGill, Adam Couvillion, Amy Rosewarne, and Joseph Jozefczyk made key contributions to this report.

GAO's Mission

The General Accounting Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to daily E-mail alert for newly released products" under the GAO Reports heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
 TDD: (202) 512-2537
 Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548