United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

September 2004

TAX ADMINISTRATION

IRS Should Take Steps to Improve the Accuracy of Schedule K-1 Data

GAO

Accountability ★ Integrity ★ Reliability

GAO-04-1040

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Highlights

Highlights of GAO-04-1040, a report to the Committee on Finance, U.S. Senate.

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TAX ADMINISTRATION

IRS Should Take Steps to Improve the Accuracy of Schedule K-1 Data

Why GAO Did This Study

Over a trillion dollars in income was distributed in tax year 2002 by flow-through entities, such as partnerships, subchapter S corporations, and trusts, to their partners, shareholders, or beneficiaries, respectively. The Internal Revenue Service (IRS) estimates that from 6 to 15 percent of such income is unreported on individual tax returns. This income is reported to both IRS and to the recipients on a Schedule K-1 (K-1). IRS uses K-1 data in its document-matching program to identify noncompliance and for other purposes. GAO was asked to (1) assess the accuracy of K-1 data, specifically transcription errors and taxpayer identification numbers (TIN); (2) determine whether any limitations in the availability or accuracy of K-1 data have affected IRS's ability to identify noncompliance; and (3) identify the benefits and challenges of increasing e-filing of K-1s.

What GAO Recommends

To improve the availability and usefulness of K-1 data to IRS for detecting noncompliance, GAO recommends that IRS conduct a pilot study to determine the benefits and costs of obtaining corrected TINs from flow-through entities as soon as they are found to be invalid.

IRS agreed with our recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-04-1040.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

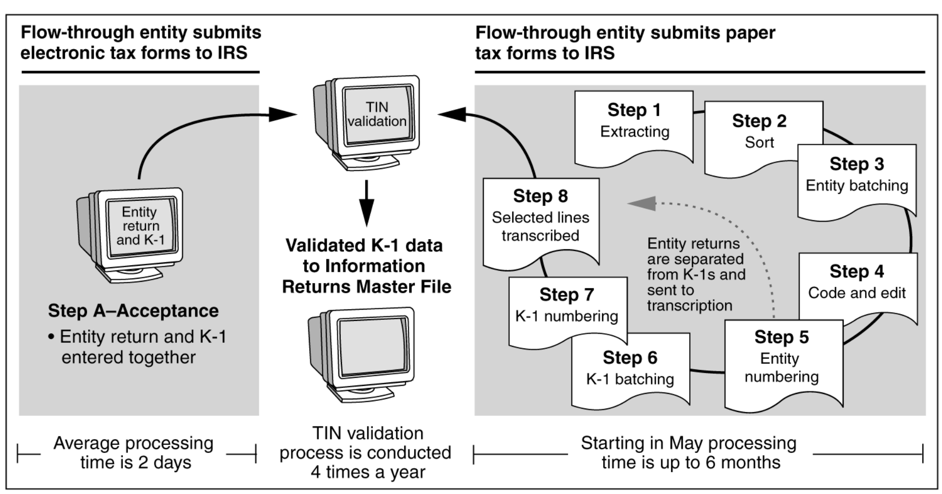
What GAO Found

The accuracy of paper-filed K-1 data is reduced by transcription errors; paper and e-filed K-1s have inaccurate TINs. IRS estimates that transcription errors for tax year 2002 ranged from 5 and 9.5 percent and is taking steps to address such errors. Although e-filed K-1s do not require transcription, for tax year 2002, the percentage of invalid TINs for e-filed K-1s and paper-filed K-1s were comparable (7 and 6 percent, respectively). Due to potential burden on flow-through entities and resource constraints, IRS does not notify the entities of invalid TINs on K-1s for correction. If IRS did so, this would likely give e-filing entities enough time to correct invalid TINs before IRS runs its document-matching program.

Inaccurate or limited K-1 data have created problems for IRS researchers and examiners. IRS research staff indicated that inaccurate TINs adversely affected their analysis of flow-through entity networks. Further, because IRS captures limited data from flow-through entity returns, including the K-1, IRS staff lack data they consider helpful, such as "Other Income" to help identify tax shelters. In at least 40 percent of closed examination cases we sampled, IRS examiners found errors with return line items not entered into IRS's databases when returns are received. If these lines were available up front, researchers say they would be able to better identify returns with potential noncompliance.

Increased e-filing of K-1s would provide benefits and challenges to both IRS and taxpayers. Benefits for IRS include faster, more complete information and millions in annual cost reductions. Benefits for taxpayers include fewer IRS contacts with them because IRS would have more accurate information in its systems. The primary challenge for IRS is its current inability to electronically process all flow-through entity returns and related forms, including the K-1. For taxpayers, the primary challenge is the cost of converting from paper to e-filing.

Paper K-1s: Lengthy Processing Yields Incomplete Data



Source: GAO analysis of IRS data.

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United States Government Accountability Office
Washington, D.C. 20548

September 30, 2004

The Honorable Charles Grassley
Chairman
The Honorable Max Baucus
Ranking Minority Member
Committee on Finance
United States Senate

Over a trillion dollars in income was distributed in tax year 2002 by entities such as partnerships, subchapter S corporations (S-Corp), and trusts that distribute net income—as well as losses—to partners, shareholders, and beneficiaries.[1] Such entities, called flow-through entities, are required to report distributed income annually to the Internal Revenue Service (IRS) on a Schedule K-1, thus providing IRS with a way to determine whether individuals are reporting the income on tax returns.[2] IRS estimates that from 6 to 15 percent of such income is unreported on individual tax returns. In addition, IRS is concerned about flow-through entities claiming improper expenses or otherwise being used to evade tax liabilities. Thus, IRS is concerned both with potential noncompliance by individuals who fail to properly report income from flow-through entities and by flow-through entities themselves, which ultimately leads to improper income reporting by individuals as well.

Schedule K-1s are one of several forms and schedules included in the annual return filed by a flow-through entity. Partnerships with more than 100 partners are currently required by law to file their annual returns, including all Schedule K-1s,[3] electronically. Those with 100 partners or less, as well as S-Corps and trusts, are not required to do so.

The annual returns of flow-through entities are used to report the income, deductions, gains, losses, and so forth of the respective entities. These returns, including the K-1s, enable IRS to identify compliance issues that

[1] An S-Corp is a domestic corporation with no more than 75 shareholders, all of which are individuals, estates, exempt organizations, or certain trusts. A trust is an arrangement by which trustees take title to property for the purpose of protecting or conserving it for beneficiaries.

[2] Although for simplicity we refer only to individuals' returns, corporations, partnerships, and trusts may also be recipients of flow-through entities' income or losses.

[3] For the remainder of this report, we will refer to Schedule K-1s simply as K-1s.

may require an examination of the flow-through entities' books and records. Further, during 2001, IRS began matching K-1 information with information included on individual tax returns to identify potential underreporting of income by individuals. To use K-1 information not filed electronically in its document-matching program,[4] IRS must first transcribe the data for use in its computer systems. As reported in 2003, this is a costly and error-prone process that can result in taxpayer burden.[5]

Because of concerns about IRS's ability to effectively use K-1 data to detect noncompliance, you asked us to assess IRS's current use of this information. Specifically, our objectives were to (1) evaluate the accuracy of K-1 data used by IRS, specifically transcription errors and invalid TINs; (2) determine whether any limitations in the availability or accuracy of K-1 data have affected IRS's ability to identify noncompliance; and (3) describe the benefits and challenges of increasing electronic filing (e-filing) of K-1s.[6]

To meet our first objective, we discussed and obtained estimates from IRS staff concerning the type of IRS transcription errors for paper-filed K-1s. We also assessed IRS's procedures related to the processing and transcription of K-1 information. In addition, we obtained and analyzed the IRS K-1 database for tax year 2002[7] to identify, among other things, the size and type of entities that file K-1s, the frequency of inaccurate taxpayer identification numbers (TIN)[8] included on these schedules, and the amount of income associated with inaccurate TINs. On the basis of our data reliability review of IRS's K-1 database, we determined that the data were

[4] The document-matching program matches information concerning selected tax issues reported on tax returns by individual taxpayers and reported on information returns by third parties, such as employers, banks, flow-through entities, and other payers of income. Transcription involves manually keypunching the information for use in IRS's computer systems.

[5] GAO, *Tax Administration: Changes to IRS's Schedule K-1 Document Matching Program Burdened Compliant Taxpayers*, GAO-03-667 (Washington, D.C.: May 30, 2003).

[6] Because the K-1 is part of the flow-through entity return, increased e-filing of the K-1 would require increased e-filing of the flow-through entity return.

[7] At the time of our review, this was the most recent year that complete K-1 data were available from IRS.

[8] The TIN is a unique nine-digit number, usually a Social Security number (SSN) for an individual, an employer identification number (EIN) assigned by IRS for a partnership or corporation, and either an SSN or an EIN for a sole proprietor.

sufficiently reliable to enable us to identify the extent to which K-1s have invalid TINs.

To address our second objective, we determined what portion of flow-through entities' returns, including K-1s, is transcribed by IRS. We also discussed with IRS staff and research consultants from MITRE Corporation[9] how IRS currently uses K-1 information and whether and how data availability and accuracy affect their ability to use these data. We also reviewed a projectable sample[10] of partnership and S-Corp closed examination files to determine the compliance issues IRS identified, the related line items that were adjusted, and whether having additional K-1 line items available would help to identify potential noncompliance. We subsequently discussed our findings with IRS classification[11] and examination staff.

To meet our third objective, we discussed with both IRS officials and officials from seven organizations that represent the taxpayer community the costs, benefits, and challenges of requiring increased e-filing of K-1s. We selected the organizations based on prior GAO knowledge and referrals from some of the organizations that we contacted. We also contacted the software companies that offer e-filing for flow-through entities to obtain their current fees for preparing and e-filing flow-through entity returns, including K-1s.

Our work was done from May 2003 through August 2004 in accordance with generally accepted government auditing standards. (App. I describes our overall objectives, scope, and methodology.)

Results in Brief

The accuracy of K-1 data is reduced by IRS transcription errors on paper-filed K-1s and by flow-through entities submitting invalid TINs on both

[9] We talked with MITRE because IRS has a contract with MITRE to conduct flow-through entity data analysis.

[10] The population from which the sample is drawn is agreed 2002 closed case examinations of partnerships and S-Corps listed in IRS's Audit Information Management System with tax years ending in 2000 or 2001. Agreed cases are cases where the IRS has made adjustments to a taxpayer's tax return, and the taxpayer has actively or passively accepted the adjustment.

[11] Classification staff, called classifiers, review returns and related documentation and select returns to be examined.

paper and e-filed K-1s. IRS estimates that the overall transcription error rate for the almost 18 million tax year 2002 paper-filed K-1s ranged from 5 to 9.5 percent based on its quality reviews. E-filed returns are not transcribed and thus do not have these errors. IRS is taking steps to reduce the transcription error rate, such as implementing a bar-coding process that bypasses the transcription process and taxpayer education and outreach efforts. In tax year 2002, IRS processed almost 1.5 million K-1s with invalid TINs. The combined income on these K-1s totaled $57.3 billion. IRS was able to correct the TINs on about half of the K-1s with income totaling $20.6 billion. The remaining 50 percent that had income of $36.6 billion could not be corrected and thus could not be used in the document-matching program. Regarding TIN accuracy, the percentage of invalid TINs for tax year 2002 e-filed K-1s was 7 percent, which was comparable to the 6 percent invalid TIN rate on paper-filed K-1s. IRS is not notifying flow-through entities of invalid TINs so they can take corrective actions due to concern over taxpayer burden on flow-through entities and resource constraints. If this were done, it would more likely give e-filing entities enough time to correct many invalid TINs before IRS runs its document-matching program because IRS could send error notices to e-filers more quickly than to paper filers.

Inaccurate or limited K-1 data have created some problems in IRS's research and examination efforts. IRS research staff studying flow-through entity relationships indicated that missing or inaccurate TINs have affected their ability to build more effective computer models to analyze flow-through networks that may be used for tax evasion. In addition, because of the limited number of line items captured from the flow-through entity return, including the K-1, research and examination staff lack certain data fields, such as "Other Income/(Loss)," that would be helpful to identify compliance issues and better target resources. Based on our sample of closed examination cases, in at least 40 percent of the examinations, IRS auditors corrected line items on entities' returns that are not currently being transcribed.[12] If these line items were available before IRS classifiers select returns for examination, IRS researchers could use the data to support more effective computer modeling and thereby focus examination classifiers' attention on returns that are more likely to involve noncompliance.

[12] Estimates from our sample are subject to sampling error. We are 95 percent confident that corrected line items not transcribed occur in at least 40 percent of the 2002 closed case examinations based on our sample evidence.

Increasing e-filing of K-1s from the current rate of about 24 percent would provide benefits and challenges for IRS and taxpayers. For IRS, the benefits include faster and more comprehensive information as well as cost reductions due to the lack of transcription costs for e-filed returns. For example, in fiscal year 2002, IRS spent over $13 million for processing and transcribing paper-filed K-1s, much of which would be eliminated. For taxpayers, the benefits of e-filing include the receipt of an IRS acceptance acknowledgment; the quicker receipt of rejection notices that would allow the taxpayers to correct problem returns faster; and more accurate information in IRS databases due to the lack of transcription errors, thus reducing the potential for erroneous and burdensome taxpayer notices. IRS's primary challenge in mandating increased e-filing of K-1s is its current inability to electronically process all the other forms that may accompany the flow-through entity return. IRS is scheduled to have this capability by 2007. The primary challenge for taxpayers is the cost of converting from paper filing to e-filing. However, based on a limited review of flow-through entity returns, most K-1s are currently computer generated, which is a prerequisite for e-filing. Also, all of the software companies that offer e-filing that disclosed their fees (about half of those we contacted) do so for less than a dollar per K-1 or at no additional cost. Both IRS and Congress are considering various administrative and legislative proposals to increase mandatory e-filing of information and tax returns, including those filed by flow-through entities.

We are making a recommendation that IRS implement a pilot study to determine the benefits and costs of requiring flow-through entities to correct invalid TINs on K-1s as soon as it has been determined that the TINs cannot be "perfected" via IRS's TIN validation program. The Commissioner of Internal Revenue agreed with our recommendation and said that IRS plans to study a number of options to ensure that TINs included on Schedule K-1s are accurate.

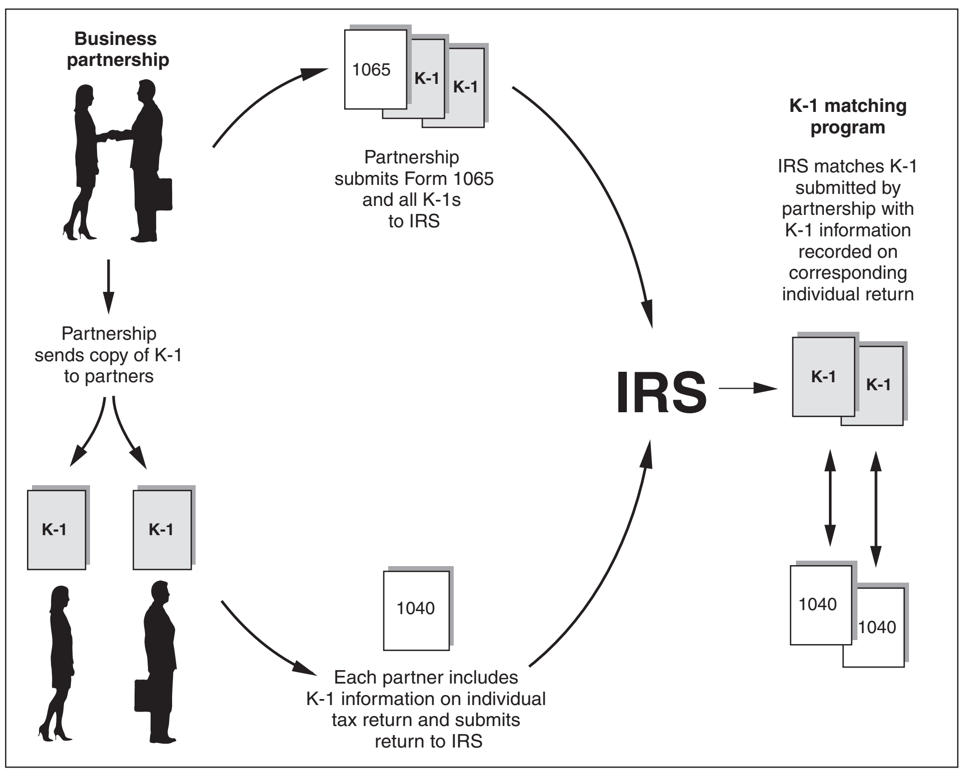
Background

Partnerships, S-Corps, and trusts are commonly referred to as flow-through entities, as they do not generally pay taxes on income. Instead, they distribute net income—as well as losses—to partners, shareholders, and beneficiaries, respectively, who are subsequently required to report the net income or loss on their individual tax returns and to pay any applicable taxes. Distributed income is reported to IRS on a K-1, which is included in the annual return filed by the flow-through entity. Copies of the Schedule K-1 are provided to partners, shareholders, and beneficiaries for use when filing their respective annual returns. Partners receive a Form 1065

Schedule K-1, “Partner’s Share of Income, Credits, Deductions, etc.”; shareholders receive a Form 1120S Schedule K-1, “Shareholder’s Share of Income, Credits, Deductions, etc.”; and beneficiaries receive a Form 1041 Schedule K-1, “Beneficiary’s Share of Income, Deductions, Credits, etc.”

As shown in figure 1, as part of its overall underreporter program, IRS has a specific K-1 document-matching program in which selected K-1 information reported by flow-through entities is compared to information reported by individuals on their tax returns in order to determine whether distributed income has been reported as required.

Figure 1: IRS’s Program to Match Flow-Through Income Reported by Partnerships with Income Reported on a Partner’s Federal Income Tax Return



Source: GAO analysis.

In like manner, income reported to IRS on a K-1 by S-Corps and trusts can be matched with income reported on tax returns by shareholders and beneficiaries, respectively.[13] The purpose of this program is to increase voluntary reporting of flow-through income by taxpayers and to target K-1 related underreporter notices to noncompliant taxpayers. IRS identified about $4.1 billion in underreported income for tax years 2000 and 2001 via the K-1 matching program and assessed about $110 million in additional taxes.[14]

In addition to use in the matching program, IRS can also use K-1 information to aid in selecting flow-through entity returns for examination. For example, IRS can use K-1 information to aid in identifying flow-through entities involved in potential tax evasion schemes and to develop computer models that may enable IRS to more effectively select returns for examination with the greatest likelihood for a tax change.[15]

In order for IRS to use K-1 information in its matching program, the information must either be e-filed by a flow-through entity or, if filed via paper, transcribed by IRS staff for use in its computer systems. Currently, only partnerships with over 100 partners are required by law to e-file their annual returns, including any related K-1s. As a result, for tax year 2002, less than one-quarter of 1 percent of partnerships was required to e-file.

Figure 2 illustrates that an e-filed K-1 goes through two basic steps before the information is input into the Information Returns Master File (IRMF). At Step A, the K-1 undergoes up-front checks prior to final acceptance by IRS, whereby the K-1 data must pass specific checks or the entire flow-through entity return is to be rejected until corrected by the entity. The up-front checks include verifying the tax year and proper formatting of names, addresses, and TINs. For example, the partner's TIN on a K-1 filed by a partnership must be within a specific range established by IRS; if not, the entire partnership return is to be rejected. The only other step for an e-filed K-1 prior to its going through IRS's document-matching program is the TIN validation process, in which the TIN and name on the K-1 are electronically

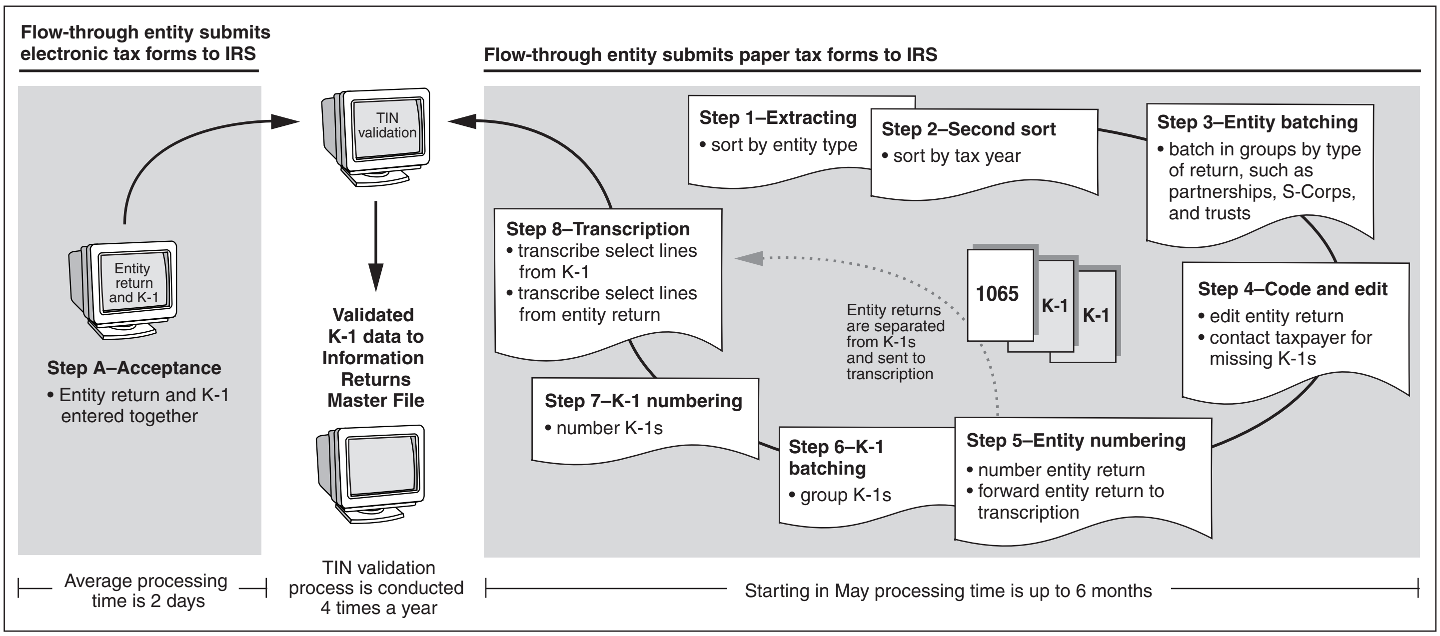
[13] For this report we focused upon the K-1 and did not assess the accuracy of the dollar amounts reported by the flow-through entity.

[14] As of May 2004, the final results for tax year 2000 were complete, while the final results for tax year 2001 were still to be determined.

[15] An IRS examination of a taxpayer's books and records that results in no tax change is generally inefficient for IRS because it has spent resources to audit an accurate return. No tax change audits also burden taxpayers, who are forced to go through the audit process even though they are compliant.

matched with information in IRS's files to determine whether the TIN is valid. Generally, this validation occurs several months after IRS accepts the e-filed return.

Figure 2: Processing Flowchart for Paper and E-Filed Schedule K-1



Source: GAO analysis of IRS data.

Note: Does not reflect the processing changes to paper K-1s that IRS began testing in April 2004 with the introduction of bar coding and scanning.

In contrast, a paper-filed K-1 goes through several manual steps, including some of the up-front checks conducted electronically for e-filed K-1s, before TIN validation takes place and the information can be input into the IRMF. These steps, particularly transcription, can take up to 6 months to complete, with transcription beginning in May. For example, at Step 4, IRS staff are to edit the flow-through entity return and contact the taxpayer if a required K-1 is missing. At Step 8, IRS staff are to transcribe selected K-1 line items. During the transcription process, the computer conducts checks on select aspects of the keypunched data, such as correlating zip code and state information, and creates an error record for correction. Subsequently, other IRS staff are to compare a sample of the transcribed K-1 data to the original paper-filed K-1 to determine whether the data were accurately transcribed. The TIN on a paper-filed K-1, as on an e-filed K-1, is not computer validated until it reaches the stage where electronic TIN validation occurs, generally several weeks or months after the return was filed.

IRS's program to electronically validate TINs matches the TIN and name on the K-1 to taxpayer identity information in its files. If there is no match, IRS will attempt to "perfect" or correct an incorrect TIN/name combination via a TIN validation process, which entails matching the TIN and name control—the first four characters of an individual's last name or the first four characters of a business name—with (1) a file which contains all Social Security numbers (SSN) ever issued and all name controls ever associated with them and (2) a file that contains all employer identification numbers (EIN) ever issued and all name controls associated with them. This TIN validation process occurs four times per year, beginning about a month and a half after the end of the filing season.

Data Transcription Errors and Erroneous TINs Reduce the Accuracy of K-1 Data

Data transcription errors made by IRS on paper-filed K-1 data and invalid TINs submitted by flow-through entities on both paper-filed and e-filed K-1s lower the accuracy of K-1 data. IRS transcription errors, which occur only for paper-filed K-1s, ranged from 5 to 9.5 percent for tax year 2002, and IRS is taking steps to reduce these errors. The percentage of invalid TINs for e-filed K-1s is comparable to that for paper-filed K-1s. However, due to potential taxpayer burden and resource constraints, IRS is not notifying flow-through entities of invalid TINs so they can take corrective actions, a step which would likely give e-filing entities enough time to correct many invalid TINs before IRS runs its document-matching program. Paper-filing entities may not have sufficient time to correct invalid TINs before document matching occurs.

Data from Paper-Filed K-1s Contain Transcription Errors, but IRS Is Taking Steps to Reduce These Errors

According to IRS K-1 quality reviews conducted at two IRS locations, the overall K-1 transcription error rate for tax year 2002 ranged from 5 to 9.5 percent—errors that by definition are not made in e-filed returns. The most frequent errors dealt with names and addresses. IRS also found transcription errors in dollar amounts and TINs. Errors detected during quality reviews are corrected before the K-1s are posted to the IRMF, which IRS uses to detect potential underreporters and nonfilers. However, less than 2 percent of all K-1s are selected for the K-1 quality review. Transcription errors on all other K-1s are included when the data are posted to the IRMF. Consequently, data from an estimated 18 million tax year 2002 paper K-1s that were entered into databases used by IRS for research and enforcement purposes have transcription error rates from 5 to 9.5 percent.[16] For example:

- IRS's K-1 database for tax year 2002 included 16 paper-filed K-1s each of which showed interest income of over $1 billion. These interest income amounts appeared to be transcription errors. One partnership filing paper K-1s had 73 partners. For 72 of the partners, the K-1 interest recorded in the IRMF was under $200,000. The remaining partner's interest as recorded in the IRMF was $85.3 billion.[17]

- According to an IRS data quality review of tax year 2001 K-1 document-matching cases, about 5 percent of the cases that were either screened out before taxpayers were contacted or resulted in no change to taxpayers' tax liabilities after an erroneous underreporter notice was sent to the taxpayer were due to transcription errors. The transcription errors included misplaced decimal points and positive money amounts that were transcribed as negative numbers and vice versa.

According to IRS officials, it would be too costly to do more data transcription quality review of paper-filed K-1s, such as reentry of K-1 data. Instead, IRS is taking other measures to improve K-1 data accuracy. For example:

- For tax year 2003, IRS began scanning all K-1s using optical character recognition (OCR) equipment. Also, for tax year 2003, IRS is accepting K-1s with bar codes that contain all the K-1 data. If the bar code is present, the system will pick up the information from the bar code, otherwise the system will image the K-1 and read the line entries using OCR. Portions of the K-1 or bar code that cannot be read by OCR are manually transcribed. Although IRS originally projected 30 percent of K-1s would be bar coded in tax year 2003, as of July 2004 only 8 percent of K-1s submitted were bar coded. For the 92 percent of K-1s without bar

[16] Some transcription errors are corrected during processing after the point of transcription. IRS did not have data on what percentage of transcription errors are later corrected.

[17] Because each partner's distributive share of income is determined by the partnership agreement (and this will be respected for tax purposes unless the allocations agreed to lack "substantial economic effect"), income may not always be distributed evenly. However, this example was selected because $85.3 billion appears to be an excessive dollar amount for interest income.

codes that OCR read, almost 20 percent required no transcription, 60 percent required less than half of normal transcription, and 20 percent were entirely transcribed. Although bar coding and OCR bypass most of the manual data transcription, which reduces some data transcription cost and errors, IRS officials still prefer e-filing because bar coding is a paper process with accompanying processing costs.

- To improve the accuracy of transcription, IRS has implemented new software and improved transcription training. At two IRS locations, IRS is using a new transcription software intended to increase transcription productivity and accuracy, compared to the current transcription software. In addition, transcription training for the K-1 program has evolved. Each year, feedback is funneled to the IRS transcription trainers to improve the K-1 transcription process.

- IRS is redesigning the K-1s for both partnerships and S-Corp returns so that IRS can scan them into the computer instead of having to transcribe the data manually. Although the redesigned partnership and S-Corp K-1s are expected to be ready by tax year 2004, the redesigned trust K-1 will not roll out until tax year 2005 because trust law makes the trust K-1 different from the other two K-1s.

- IRS is conducting educational outreach to increase accurate K-1 filing and provide updates to changes in K-1 design. In April 2004, IRS issued a news release to provide tips for businesses, individuals, and tax professionals on accurate K-1 filing. For example, flow-through entities are instructed to ensure the correct TINs are used on K-1s. In addition, the six IRS Tax Forums in 2004 include a session on reporting flow-through items, which addresses the redesign of K-1 forms and K-1 reporting reminders. IRS has also included updates on the K-1 matching program and K-1 redesign in external speeches to stakeholder groups. Finally, in late 2004, IRS plans to implement a multifaceted communication plan to publicize the release of the redesigned K-1s.

IRS's K-1 Data Contain Incorrect Taxpayer Identification Information

For IRS to use K-1 data in its document-matching program, the TINs and names on K-1s need to be accurate so they can be linked to individuals' tax returns and other tax documents. In tax year 2002, about 94 percent of 24 million K-1s that IRS processed contained valid TINs. The remaining 6 percent, or approximately 1.5 million K-1s, had invalid TINs because either IRS made transcription errors or the flow-through entities submitted invalid data. The 1.5 million K-1s with invalid TINs had combined income gains of $57.3 billion and combined income losses of $84.1 billion. IRS was able to correct the invalid TINS on about 750,000 of the K-1s, with income gains totaling $20.6 billion and incomes losses totaling $6.8 billion, so that they could be used in IRS's document-matching program or for other compliance and research purposes. However, the remaining 740,000 K-1s with invalid TINs, with income gains of $36.6 billion and incomes losses of $77.2 billion, could not be perfected and thus were unmatchable. IRS did not have data on the number of K-1s that had either corrected or unmatchable TINs in the IRMF that resulted from transcription errors.

IRS Does Not Notify Flow-Through Entities of Invalid TINs That It Was Unable to Correct

After IRS checks the validity of TINs provided on K-1s, it does not notify either paper-filing or e-filing flow-through entities of the invalid TINs it finds so the entities can take steps to correct the TINs, due to concerns about the potential burden on the entities and resource constraints. Because e-filed returns do not go through time-consuming paper processing steps, including transcription, if IRS were to notify the originating entities of invalid TINs, they should have time to correct invalid K-1s before IRS performs its document matching in the fall following a tax filing year. For paper-filed K-1s, many entities likely could not respond before the document matching occurs.

Because e-filed K-1s are not subject to transcription errors, none of the keypunching errors associated with paper returns are in e-filed data. However, as table 1 shows, in tax year 2002 the overall percentage of invalid K-1 TINs IRS found with its TIN validation program was comparable for e-filed (about 7 percent) and paper (6 percent).

Table 1: Percentage of Invalid Schedule K-1 TINs That Were Not Corrected and Corrected by IRS for Tax Year 2002 by Type of Entity Return

	E-filed K-1s			Paper K-1s		
Type of entity return	Percentage of TINs found invalid by IRS's validation program	Percentage of invalid TINs IRS was unable to correct	Percentage of invalid TINs IRS corrected	Percentage of TINs found invalid by IRS's validation program	Percentage of invalid TINs IRS was unable to correct	Percentage of invalid TINs IRS corrected
Partnership	8.7	62.1	36.8	6.5	50.8	49.2
Trust	3.7	24.3	75.7	7.1	56.3	43.7
S-Corp	n/a[a]	n/a[a]	n/a[a]	5.0	36.0	64.0
Total all K-1s	**7.0**			**6.1**		

Source: GAO analysis of IRS information.

Note: Numbers may not add up to 100 percent because of rounding.

[a]Not applicable because e-file was not available for S-Corp returns until tax year 2003.

Factors that may be contributing to e-filed K-1s having TIN errors comparable to those of paper K-1s include (1) large partnerships, which are mandated to file K-1s electronically, submitting such large volumes of K-1s that many may unknowingly submit one or more K-1s with invalid TINs[18] and (2) IRS not applying one of its up-front checks for e-filed partnership K-1s.

According to our analysis of IRS's K-1 database, partnerships that submit a higher volume of K-1s are more likely to submit a K-1 with an invalid TIN compared to partnerships that submit only a few K-1s. In tax year 2002, e-filed partnerships' K-1s had the highest rate of invalid TINs (8.7 percent). That same year, 97 percent of the partnerships with more than 100 partners, which are required to e-file, submitted at least one K-1 with an invalid TIN. In contrast, 18 percent of partnerships with 100 or fewer partners submitted at least one K-1 with an invalid TIN.

To encourage electronic filing of partnership returns, IRS is not applying its up-front check that would reject an e-filed partnership's return if it has even one TIN on a K-1 that falls outside the range of numbers associated with SSNs and EINs. If IRS applied this validation criterion in tax year 2002, 12 percent of the e-filed partnership K-1s with unmatchable TINs would have

[18] Each partner has a unique TIN.

been rejected and the originating entities would have been asked to take steps to correct the TINs. However, some partnerships have hundreds or thousands of partners, making it more challenging for them to ensure that all partners' TINs are correct. IRS officials have determined that accepting an e-filed return when the vast majority of the K-1 TINs fall within the range of numbers associated with SSNs and EINs, rather than rejecting the entire entity return due to one or a few TINs that fall outside that range, promotes e-filing.

In addition, IRS does not notify either e-filing or paper-filing flow-through entities if submitted TINs are found to be invalid during the TIN validation checks it performs subsequent to accepting entities' returns. In tax year 2002, more than half of the K-1s submitted by 2 percent of the flow-through entities contained invalid TINs. The total number of unmatchable K-1s submitted by these entities represented about 29 percent of the total number of K-1s with unmatchable TINs. IRS officials said that requiring flow-through entities to correct invalid TINs could be a burden because the entities rely on information supplied by individual taxpayers and the correct TINs may not be readily available, particularly for those entities submitting a large number of K-1s. In contrast, IRS does notify filers of missing or invalid TINs submitted on other types of information returns, which then may require the filers to contact third parties for corrected information. For example, for tax years 2000 and 2001 combined, IRS proposed just over $204 million in penalties against nonfederal payers for information returns with invalid TINs. IRS officials acknowledged that flow-through entities may have made mistakes themselves that resulted in invalid TINs or may have the correct information on hand. They also stated that sending such notices would entail some additional cost to IRS and that they currently face resource constraints. However, IRS officials do not have estimates of either the potential benefits, such as increased revenue obtained from document matching utilizing accurate TINs, or the cost to IRS of obtaining valid TINs from flow-through entities.

If IRS were to notify flow-through entities of invalid TINs and ask that they take steps to correct the TINs, it likely would be able to receive many corrected TINs, particularly from e-filers, in time for its annual document-matching program. IRS does its document matching generally from November of the calendar year through January of the following year. The time when document matching occurs changes somewhat from year to year. IRS corrects TINs, including K-1 TINs, four times a year: at the end of June, early September, mid-November, and late November. Based on the IRS's 2001 Statistics of Income samples, at least 97 percent of partnerships and S-Corps filed calendar year returns.[19] Consequently, all of these returns were due to be filed prior to IRS's first TIN validation check in June.[20] Since IRS accepts e-filed returns within 2 days of their submission, all e-filed returns for which filers have not requested extensions should be available for IRS's June TIN validation program. In this case, IRS would be able to notify the flow-through entities of the invalid TINs and the entities would have several months to correct the TINs and get them back to IRS before IRS posts the corrected K-1s to the IRMF in time for use in the document-matching program. Even if a flow-through entity did not submit the corrected TIN in time, the entity would be aware of the error and could correct the TIN for the following year.

For paper-filing flow-through entities, fewer entities likely would be able to correct invalid TINs in time for inclusion in the document-matching program. Transcription of paper-filed entity returns, including K-1s, begins in May. Because transcription can take up to 6 months, a significant portion of paper-filed entity returns and associated K-1 TINs likely would not be available for the June TIN validation. For those not available until the early September TIN validation, the entities would have much less time to correct TINs and get back to IRS in time for IRS to include the corrected TINs in the document-matching program. Because IRS's new return scanning and bar-coding efforts should make paper-filed return data available more quickly, IRS may be able to include more of them in the June TIN validation and thus provide entities sufficient time to provide corrected TINs if it sends notices of invalid TINs to flow-through entities.

K-1 Data Accuracy and Availability Pose Problems in Research and Examination Efforts

In addition to using K-1 data in its document-matching program, IRS is using K-1 data in its research programs to better understand flow-through relationships. When data such as TINs are unavailable or inaccurate, researchers are unable to establish a complete understanding of the network of related entities and taxpayers. Data limitations have also affected IRS's efforts to identify potentially noncompliant taxpayers for examination. IRS researchers and examination staff indicated that more

[19] These figures are based on sample data and subject to sampling error. We are 95 percent confident that the percentages exceed the value shown for the tax year 2001 partnerships and S-Corps.

[20] In general, for calendar year filers, S-Corp returns are due to be filed by March 15 and partnership returns are due by April 15.

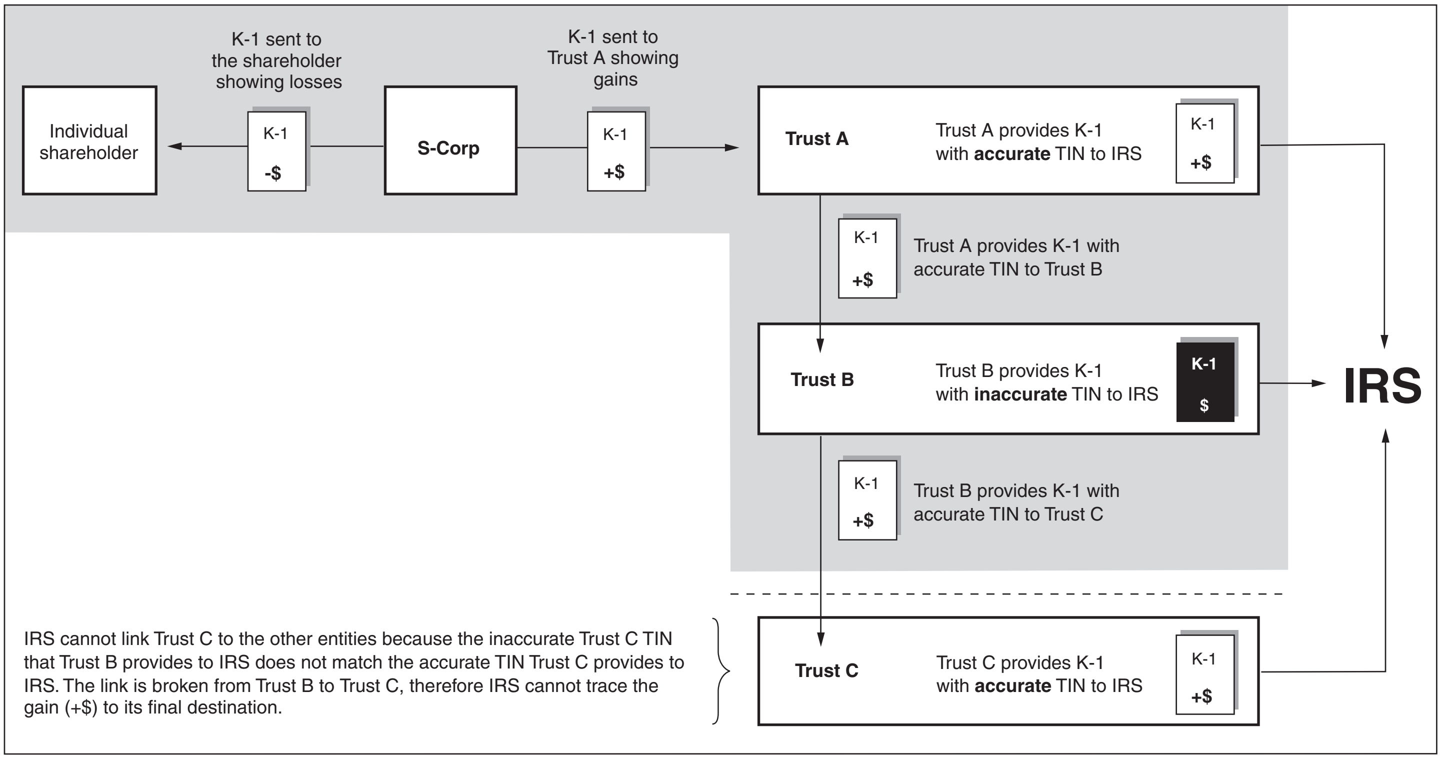
complete and accurate data would enhance their efforts to detect noncompliance.

Inaccurate TINs Affect Research Efforts to Link Related Entities

IRS researchers are using K-1 data to visualize how taxpayers are related to different entities and to evaluate whether compliance issues may exist with flow-through entities. However, inaccurate TINs have sometimes prevented researchers from establishing all relevant links in a network of related entities. As a result, IRS is less able to track the flow of income and losses among entities and could be missing opportunities to address areas of noncompliance.

Figure 3 illustrates how inaccurate TINs may prevent IRS from tracking the flow of income through a chain of financial transactions. In this example, an S-Corp distributes losses to an individual shareholder, possibly to allow the shareholder to offset other gains, and distributes income to another shareholder, a trust. Since trusts are flow-through entities and may be nontaxable, the individual shareholder may be using the trust to reallocate income (perhaps to someone in a lower tax bracket) that would otherwise need to be reported and taxed on that individual's return.

Figure 3: How Inaccurate TINs May Prevent IRS from Tracking Flow of Income through a Chain of Financial Transactions



Source: GAO analysis of IRS data.

In our example, the S-Corp transfers income to Trust A, which in turn transfers the income to Trust B. In both transactions, the S-Corp and Trust A submit K-1s with accurate TINs to IRS, so IRS can track the flow of income between the entities. Trust B then transfers the income again to Trust C and submits a K-1 with an inaccurate TIN to IRS. Because of the inaccurate TIN on the K-1, IRS would likely be unable to identify that Trust C is related to the other entities or track the flow of income to its final destination and ultimately determine whether any income was underreported.

Limited Transcription Lines Do Not Fully Meet the Needs of Examination and Research Programs

IRS transcribes limited line items from K-1s that accompany partnership and S-Corp returns. According to IRS staff, at least some of the nontranscribed lines would provide useful information. Similarly, IRS does not transcribe many of the lines from the flow-through entity's return to which the K-1s are attached. Since e-filing of the full entity's return is part and parcel of achieving e-filing of K-1s, e-filing of K-1s would have the additional effect of making the complete entity's tax return information available to IRS examiners and researchers. Complete entity data also would provide useful information for research and examination purposes. For K-1s, IRS identified the line items to be transcribed based on the needs of its document-matching program and not on other potential uses.

Regarding K-1s, IRS transcribes about 14 percent of partnership K-1 line items and about 17 percent of S-Corp K-1 line items. Research and examination staff indicated that the nontranscribed information would provide useful information. For example:

- The "Other Income/(Loss)" line is not captured from the K-1 because it is not useful for document matching, but it can be helpful to researchers in identifying abusive shelters, for example, where the gain is allocated to a tax haven country and the loss is allocated to a domestic investor.

- Transcribing the shareholder's ownership percentage from the K-1 would more easily allow classifiers to determine if the taxpayer has a controlling interest in the S-Corp and if income/losses are distributed evenly.

Regarding the flow-through entity's return, IRS currently transcribes about 23 percent and 20 percent of the line items for partnership and S-Corp returns, including the K-1, respectively. As discussed below, additional data from the full entity return would potentially benefit examination and research programs. For example:

- The *IRS Examination Guide for Abusive Tax Shelters and Transactions* lists partnership (Form 1065) and S-Corp (Form 1120S) tax return lines that when examined with other information, may indicate tax shelter transactions. For partnership returns, about 80 percent of the line items listed in the guide as useful to detect tax shelters are not captured in IRS's database. For S-Corp returns, about 87 percent of line items listed are not captured. When selecting returns to be examined, IRS classifiers who focus on tax shelter issues lack information that may identify taxpayers most likely to be using tax shelters.

- IRS researchers developed a computer model to better identify S-Corp returns for examination by helping classifiers separate accurate returns from those needing further investigation. The model uses data from IRS's database of business returns, including Form 1120S and accompanying schedules. From the approximately 23,000 returns that the model analyzed, IRS identified about 58 percent of the returns as having low potential for noncompliance and therefore eliminated them from the universe that might be examined. The remaining 42 percent of returns could not be classified because the model did not have enough data to evaluate them. As a result, IRS has continued to rely on examination staff who focus on S-Corp compliance issues to manually review the returns that the model has not been able to classify. To help address the lack of 1120S data, IRS will be capturing 10 additional line items from the 1120S for tax year 2003. One IRS researcher estimated that the 10 additional 1120S line items would enable the computer model to identify 15 S-Corp compliance issues compared to its current capability of identifying 2 compliance issues.

From our file review of closed S-Corp and partnership tax return examination cases and discussions with IRS examination and research staff, we also found that additional line items from the K-1 and other parts of the entity's return may assist IRS in selecting tax returns to examine. Based on our sample of closed examination cases,[21] in at least 40 percent of the examinations, IRS corrected line items that are currently not transcribed. IRS examination and research staff we interviewed indicated that if IRS captured this information and made it available to them, it would help them identify those returns with errors or omissions that IRS should examine. Most of the nontranscribed line items that were corrected were from Schedule A (Cost of Goods Sold) and Schedule K[22] (Partners' Shares of Income, Credits, Deductions, etc., or Shareholders' Shares of Income, Credit, Deductions, etc.) for both partnerships and S-Corps. IRS identified two of these line items, both from Schedule K and K-1, as important for improving the effectiveness of computer modeling and mentioned other nontranscribed lines, such as "Short Term Capital Loss," from the entity return that would be useful.

[21] See app. I for information regarding the sample population.

[22] Schedule K is a summary schedule of all partners' or shareholders' shares of the partnership's or S-Corp's income, credits, deductions, and so forth. Schedule K-1 shows each partner's or shareholder's separate share. In our file review, we noted adjustments on Schedule K, unless the adjustment was specific to Schedule K-1.

Increasing E-Filing of K-1s Would Provide Benefits and Challenges for IRS and Taxpayers

Increasing e-filing of K-1s provides benefits and challenges for IRS and taxpayers. The benefits for IRS are faster and more comprehensive information as well as cost reductions. The benefits to taxpayers are the receipt of acknowledgment notices, faster rejection notices that allow taxpayers to resolve problems faster, and more accurate information. Currently IRS's main challenge is the lack of complete e-filing capacity, but IRS is scheduled to have this capacity by 2007. The main challenge for taxpayers is the cost of converting from paper to e-filing. However, limited data indicate that most K-1s are computer generated, which is a prerequisite for e-filing. Also, all of the software companies that offer e-filing that disclosed their fees (about half of those we contacted) do so for less than a dollar per K-1 or for no additional charge. Congress has mandated that IRS increase e-filing to at least 80 percent of all tax and information returns by 2007. Currently, both IRS and Congress are considering increasing mandatory e-filing of flow-through entity returns.

Increasing E-Filing of K-1s Would Provide Better Information and Cost Reductions for IRS

Currently, IRS electronically receives about a quarter of the K-1s filed, although only partnerships with more than 100 partners are mandated to e-file. Increasing e-filing of K-1s would benefit IRS because of the following:

E-filing K-1s provides IRS with faster and more complete information for use in compliance and research programs. A recent Treasury Inspector General for Tax Administration (TIGTA) report stated that the savings in processing time resulting from e-filing would significantly affect IRS's attempt to reduce its lengthy corporate examination process. In addition, the TIGTA report stated that comprehensive electronic information would minimize the number of no change audits by enabling IRS to better target resources to issues that have the greatest compliance risk.[23]

- E-filing K-1s would save IRS millions of dollars a year because it would eliminate the processing and transcription costs of paper K-1s. According to IRS, the cost to process e-filed K-1s is minimal once the systems are in place, while processing and transcribing paper K-1s cost IRS $14.6 million in fiscal year 2001 and $13.1 million in fiscal year 2002. If IRS was able to re-allocate these cost savings, IRS could, for example,

[23] Treasury Inspector General for Tax Administration, *New Regulations Are Needed to Take Full Advantage of the Opportunities Offered by Filing Large Corporate Income Tax Returns Electronically*, 2003-30-123 (Washington, D.C.: May 30, 2003).

pay the salaries of 284 additional field collection revenue officers. While, as noted earlier, some of the processing and transcribing costs will be reduced because of bar coding and scanning, IRS regards bar coding as a lesser alternative to e-filing. In addition, bar coding results in incomplete information because only the transcribed lines are scanned into the computer systems, and the K-1s are the only part of the entity return that is bar coded. Also, there is limited availability of software that has bar-coding capacity; only four software companies provide bar-coding capability compared to 19 software companies that provide e-filing.

The primary benefits for taxpayers of increasing e-filing are as follows:

- Taxpayers that e-file will receive electronic acceptance or rejection notices within 2 days of submitting tax returns. The tax form is electronically transmitted to the software company and then the software company transmits the tax return to IRS. IRS sends the software company an electronic acceptance or rejection notice within 2 days, and the software company then sends the notice to the taxpayers. Taxpayers that file paper returns do not receive acceptance notices and thus do not have proof that the returns were filed on time in case the tax returns are lost. E-filing taxpayers also receive rapid rejection notices and are thus informed of problems much faster than paper-filing taxpayers, who may wait for 6 months for IRS to process tax returns.

- The information on an e-filed tax return should be more accurate because of the lack of IRS transcription errors. More accurate information would reduce the potential for burdensome taxpayer notices resulting from transcription errors. To respond to IRS notices, taxpayers and preparers are required to collect, organize, and submit information to IRS to explain any discrepancies cited in the notices, which requires an investment of both the taxpayers' time and money. In recent reports, TIGTA noted that e-filing would eliminate transcription errors that result in erroneous and burdensome taxpayer notices.[24]

[24] Treasury Inspector General for Tax Administration, *The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedule K-1*, 2003-30-071 (Washington, D.C.: Mar. 14, 2003), and *New Regulations Are Needed to Take Full Advantage of the Opportunities Offered by Filing Large Corporate Income Tax Returns Electronically.*

Increasing Electronic Filing of K-1s Requires Complete IRS E-Filing Capacity and Taxpayers' Conversion from Paper Filing to E-Filing

The primary challenge for IRS of mandating increased e-filing is to implement computer systems that can electronically process the complete set of tax documents that flow-through entities may file with K-1s. Although IRS currently has the capacity to electronically process K-1s that accompany flow-through entity returns, IRS is unable to electronically process all the forms that accompany those of trusts and partnerships. This impedes e-filing of the flow-through returns with accompanying K-1s because taxpayers that submit partnership and trust returns (that include three-fourths of K-1s) have to submit both paper and electronic documents—a disincentive for e-filing. For example, signature forms have to be sent in on paper. In contrast, IRS currently has complete e-filing capacity for the entire S-Corp return, so no forms have to be filed on paper. IRS is scheduled to have complete e-filing capacity for partnerships and trusts, but has pushed the completion date for this effort from 2006 to 2007 due to limited resources.

The main challenge to expanded use of e-filing for taxpayers is the cost of converting from paper filing to e-filing. In separate reviews of flow-through entity returns by IRS and GAO, the majority of the tax returns were found to be computer generated, prepared by a paid preparer, or both, which might make the conversion to e-filing easier. Based on our sample of Audit Information Management System agreed closed case examinations of partnerships and S-Corps with tax years ending in 2000 or 2001, paid preparers prepared at least 84 percent of the returns, and at least 90 percent of the returns were computer generated.[25] Of the nonprojectable sample of 200 partnership and trust returns that IRS reviewed, a paid preparer prepared 169 returns, and 173 were computer generated.[26]

Since the above-mentioned reviews of flow-through entity returns indicate that a paid preparer prepares the majority of returns that accompany K-1s by computer, the cost to convert to e-filing may be marginal or nonexistent. If a paid preparer is using software that has e-filing capacity, then taxpayers can simply choose to use this option, which can entail a marginal cost increase. According to our survey of the software companies that offer e-filing of partnership, trust, and S-Corp returns, all of the software

[25] These figures are subject to sampling error. We are 95 percent confident that the percentages exceed the values shown.

[26] IRS reviewed a nonprojectable sample of tax year 2000 partnership and trust returns from the Austin Service Center.

companies that disclosed their fees (about half of those we contacted) either charge from $0.30 to $0.90 per e-filed K-1 or include the option to e-file in the price of the software. In order to e-file, flow-through entities have to buy the software and e-file the entire flow-through entity return, at costs that vary from $3.50 per return to over $15,000 for comprehensive support for partnership returns, corporate income tax returns, and affiliated forms. For partnerships, if the paid preparer does not use software with e-filing capacity and the data are formatted according to IRS's specifications, paid preparers can send the partnership return electronically to a software company that will then electronically transmit the partnership return. One software company stated that it would generally charge $0.40 per K-1.

IRS and Congress Are Considering Increasing E-Filing

According to IRS officials, IRS is considering mandating increased e-filing of information and tax returns, including those of flow-through entities. In recent reports, TIGTA has recommended that IRS should work with the Department of the Treasury to mandate increased e-filing of flow-through entity returns, either through current regulatory provisions or through legislative action.[27] As a result, IRS is currently studying the possibility of increasing mandated e-filing of flow-through entities' returns with accompanying K-1s under Internal Revenue Code (I.R.C.) Section 6011 as part of an agencywide initiative to increase e-filing to meet a congressionally mandated goal of having at least 80 percent of all tax and information returns filed electronically by 2007.[28] IRS's study includes the cost for taxpayers to convert from paper filing to e-filing, the cost for IRS to initiate and administer increased mandated e-filing, the perspective of the paid tax preparer and business communities, and how to implement increased mandated e-filing. In addition, according to IRS officials, IRS is also considering mandating e-filing for those returns for which IRS has complete e-filing capacity.

[27] Treasury Inspector General for Tax Administration, *The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedule K-1* and *New Regulations Are Needed to Take Full Advantage of the Opportunities Offered by Filing Large Corporate Income Tax Returns Electronically.*

[28] The TIGTA report noted that although there are restrictions under current law prohibiting IRS from requiring individuals, estates, or trusts to file electronically, there are no restrictions against IRS requiring through regulations that corporate and other types of returns be filed electronically.

In addition, Congress is currently considering the Tax Administration Good Government Act of 2004,[29] which would permit IRS to mandate increasing e-filing of flow-through entity returns and accompanying forms, such as K-1s, in two new ways. First, the law would remove the present restrictions in I.R.C. Section 6011 that prevent IRS from mandating individuals, estates, and trusts to e-file. Since the law would remove the restriction on mandating e-filing of individuals, IRS would then be able to mandate e-filing by paid preparers that prepare individual tax returns. Second, the law would lower the threshold at which IRS could mandate e-filing of information and tax returns for any taxpayer to 5 returns. Currently, the threshold is 250 returns. Thus, IRS could mandate e-filing by paid preparers who file 5 or more flow-through entity returns or individual tax returns.

Conclusions

Although there are some costs to taxpayers to e-file and to IRS in processing e-filed flow-through entity returns and related K-1s, in general e-filed K-1s offer substantial advantages for both IRS and taxpayers. We are not making a recommendation for further action to expand e-filing of flow through-entities' returns, including K-1s, because IRS agreed to take steps to do so pursuant to a TIGTA recommendation and is currently studying the costs of increasing e-filing to IRS and taxpayers. One step, upgrading its overall capability to accommodate an increase in e-filed flow-through entity returns, including K-1s, is under way. However, we are concerned that IRS's estimated date for having this capacity has been pushed back to 2007 due to limited resources. The sooner this can be accomplished, the sooner IRS can reap the potential benefits of an increase in e-filed Schedule K-1s while moving closer to achieving the congressionally mandated goal of having 80 percent of all federal tax returns and information returns filed electronically by 2007.

Regardless of whether e-filing is expanded, IRS is missing an opportunity to improve the accuracy of TINs associated with K-1s and thereby is undermining the benefits that can be realized from its document-matching program, efficient targeting of examination resources, and new research to identify noncompliance. Although IRS officials expressed concern about the possible burden on flow-through entities of dealing with TIN error notices and about IRS's ability to deal with the costs of sending such notices given its resource constraints, IRS does not have information on

[29] H.R.1528.

the likely benefits and costs of sending TIN error notices to flow-through entities. Given the high concentration of TIN errors among a small portion of flow-through entities, even if costs are high compared to the benefits of sending notices to some flow-through entities, the situation may be much different for error-prone flow-through entities.

Recommendation for Executive Action

To improve the availability and usefulness of Schedule K-1 data to IRS for detecting noncompliance, we recommend that IRS conduct a pilot study to determine the benefits and costs of requiring flow-through entities to correct invalid TINs on K-1s as soon as it has been determined that the TINs cannot be "perfected" via IRS's TIN validation program.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Commissioner of Internal Revenue, which are reprinted in appendix II. The Commissioner agreed with our assessment of Schedule K-1 TIN accuracy and that a pilot project would be useful in identifying ways to improve TIN accuracy. He said that IRS plans to study a number of options to ensure that TINs included on Schedule K-1s are accurate, including our recommendation that IRS conduct a pilot study to determine the benefits and costs of obtaining corrected TINs from flow-through entities. The Commissioner said that IRS's Flow-Through Compliance Committee recently initiated a project to study invalid TINs on Schedule K-1s to determine their potential compliance impact. In addition, he also mentioned other initiatives, such as form redesign, outreach efforts, and scanning Schedule K-1s, to improve the overall effectiveness of flow-through compliance efforts.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies to the Chairman and Ranking Minority Member, House Committee on Ways and Means, and the Chairman and Ranking Minority Member, Subcommittee on Oversight, House Committee on Ways and Means. We will also send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. The report will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you have any questions concerning this report, please contact me at (202) 512-9110 or brostekm@gao.gov or Jonda Van Pelt at (415) 904-2186 or vanpeltj@gao.gov. Key contributors to this report were Ralph Block, Maya Chakko, Keira Dembowski, Elizabeth Fan, Robert McKay, and Samuel Scrutchins.

Michael Brostek
Director, Tax Issues

Objectives, Scope, and Methodology

Our objectives were to (1) evaluate the accuracy of K-1 data used by the Internal Revenue Service (IRS), specifically transcription errors and invalid taxpayer identification numbers (TIN); (2) determine whether any limitations in the availability or accuracy of K-1 data have affected IRS's ability to identify noncompliance; and (3) describe the benefits and challenges of increasing electronic filing of K-1s.

To evaluate the accuracy of K-1 data used by IRS, we requested, obtained, and analyzed data from IRS's K-1 database for tax year 2002.[1] We examined two versions of the database, both of which had been modified from the original K-1 database by IRS research analysts. One, called the K-1 "cleaned database," has original K-1s removed when possible where duplicate or amended K-1s for the same taxpayer were subsequently submitted by the parent flow-through entity. The second, called the "money-cleaned database," also has all amounts that were obvious transcription errors removed. Generally, these were amounts in excess of $900 million and that exceeded the total amount reported on the parent flow-through entity's Schedule K for the particular line item. We used the "cleaned database" to identify one such transcription error.

We analyzed the "money-cleaned" database to identify the number of K-1s that were filed with inaccurate TINs by type of flow-through entity (partnership, subchapter S corporation (S-Corp), or trust) and by type of submission (e-filed versus paper filed). We subsequently analyzed this subset of K-1s to determine the number and total income of K-1s with invalid TINs that IRS (1) was able to perfect via its TIN Perfection Program and (2) could not perfect and thus remained invalid and, in effect, unusable for compliance or research purposes. Because specific data were unavailable from the K-1 database concerning transcription errors, we conferred with IRS analysts to identify the type of transcription errors found during K-1 product reviews they conducted from July through November 2003.

To identify whether any limitations in the availability or accuracy of K-1 data have affected IRS's ability to identify noncompliance, we obtained from IRS the line items the agency transcribes from the K-1 and related flow-through entity returns. When we calculated the percentage of line items transcribed from the entity return, we included the K-1 as part of the

[1] At the time of our review, tax year 2002 was the most recent year for which complete K-1 data was available from IRS.

return. To count line items, we included all labeled lines and sub lines, but excluded certain fields, including calendar or tax year, name and address, supplemental information/attachments, signature and date, preparer's signature and date, preparer's self-employment, and preparer's firm name and address.

We also interviewed IRS examination and research staff, as well as outside research consultants from the MITRE Corporation, with whom IRS contracted to analyze flow-through entities. Specifically, we discussed how IRS currently uses K-1 data to select flow-through entity returns for examination, how IRS research staff and research consultants are using K-1 data to develop analytical tools to aid IRS in better targeting returns for examination, and how data limitations affect their ability to effectively use K-1 information.

To determine the compliance issues IRS identified and the related line items that were adjusted, we reviewed a stratified probability sample of partnership and S-Corp tax returns. We selected these returns from the population of 253 partnership and 1,121 S-Corp agreed closed examination cases listed in the IRS Audit Information Management System 2002 Closed Case database with tax years ending in 2000 or 2001. We reviewed a sample of 107 returns of which 91 returns, consisting of 52 of the partnership and 39 of the S-Corp returns, could be analyzed. The remaining 16 returns could not be analyzed, generally because the examination workpapers were not available or the case adjustments were based on unusual circumstances, such as amended return submissions from taxpayers. We used this sample of 91 returns to estimate several characteristics[2] of this population of all 1,374 agreed partnership and S-Corp cases.

Because these estimates are based on a probability sample, our sample is only one of a large number of samples that we might have drawn. Since each sample could have provided different estimates, we express our confidence in the precision of our particular sample's results as a one-sided 95 percent confidence interval. For example, paid preparers prepared an estimated 93 percent of the returns, and a one-sided 95 percent confidence interval for this estimate has a lower bound of 84 percent. Since the actual population value would be contained in this interval for 95 percent of the

[2] These estimates are the percentage of returns with adjusted line items not currently transcribed, percentage of paid preparer prepared returns, and percentage of computer-generated returns.

samples we could have drawn, we are 95 percent confident that the proportion of paid preparer returns in the study population exceeds 84 percent. Similarly, for the adjusted lines found in the file review, we are 95 percent confident that adjustments made to nontranscribed line items occur in at least 40 percent of the examinations.

We subsequently discussed our file review findings with IRS research and examination staff to obtain their views regarding whether having additional K-1 data available, such as line items not currently transcribed, would increase their ability to identify returns with compliance issues.

To describe the benefits and challenges of increasing e-filing of K-1s, we discussed this issue with IRS officials and officials from seven organizations that represent the taxpayer community. We selected the organizations based on prior GAO knowledge and referrals from some of the organizations that we contacted. From IRS officials, we obtained estimates of the cost to transcribe K-1 information, to help identify the potential cost savings if K-1s were e-filed. We also discussed IRS's current requirements for mandating e-filing K-1s and IRS's experience in enforcing these requirements, and obtained data on penalties levied for failure to e-file required K-1s. Finally, we discussed IRS's current and future ability to electronically process an increase in the number of e-filed flow-through entity returns, including K-1s. We also contacted all 19 of the software companies that offer e-filing for flow-through entities and received e-mail responses from just over half of the companies. From officials with the software companies, we obtained their current fees for preparing and e-filing flow-through entity returns and K-1s.

To determine how many flow-through entities filed on a calendar year basis we used the 2001 Partnership and Corporation Statistics of Income (SOI) samples.[3] The SOI partnership data we used included the entire sample, but the SOI corporation data we used were limited to the flow-through S-Corps. Because these are probability samples, the SOI estimates are subject to sampling error. We produced estimates from these samples using SOI's sampling weights and methods that are appropriate for stratified probability samples. In this report we present these estimates as

[3] SOI last published information for estate and trust returns for tax year 1997.

intervals, reporting the lower bound on one-sided 95 percent confidence intervals.[4]

We did our work at IRS headquarters in Washington, D.C., as well as at the Ogden, Utah, Processing Center and the Oakland, California, Area Office from April 2003 through July 2004 in accordance with generally accepted government auditing standards.

Data Reliability

We assessed whether the information contained in the K-1 databases, the two SOI databases, and the Audit Information Management System (AIMS) database were sufficiently reliable for the purposes of this report. We ensured that the copies of all five databases we received from IRS were identical to the original databases based on record counts and analyses of control totals, comparison to published data, or both. In addition, we performed electronic tests on the each database to search for missing data and obvious errors.

For the original K-1 database from which the two cleaned versions we used originated, we assessed IRS's procedures for processing and transcribing Schedule K-1 data. We also assessed other procedures and methodologies IRS research analysts used to remove duplicate records and obvious errors from transcribed monetary fields. We anticipated the K-1 database would have some reliability issues because our engagement was designed in part to assess the sufficiency of the data transcription effort. While large monetary transcription errors were removed from the "money-cleaned" database, additional, undetectable transcription errors of amounts within normal ranges may remain.

For the AIMS 2002 Closed Case database, we relied exclusively on variables that allowed us to identify agreed closed case partnerships and S-Corps, as this was the population of cases from which we drew our sample. We interviewed IRS personnel who manage the AIMS databases and found that groups in IRS conducting examinations are required to validate annually that completed examination cases are actually shown as having been closed. In addition, we collected data from original returns during our data collection effort and compared those data to data contained in the

[4] Additional information regarding the IRS's SOI program and its stratified probability samples is available on the Internet at www.irs.gov/taxstats/.

AIMS database. We found no indication that our sample contained ineligible cases.

SOI samples are widely used for research purposes. We have documented for recent reports[5] that IRS performs a number of quality control steps to verify the internal consistency and completeness of SOI sample data. The agency uses similar quality control procedures for all types of SOI samples. For example, the agency performs electronic tests to verify the relationships between values on the returns selected as part of the SOI samples and manually edits data items to correct for problems, such as inaccurate and missing items. Because we used the partnership and corporate samples only to determine the percentage of partnerships and S-Corps that were calendar year filers, we needed no more than four variables from each database to make this analysis. We checked these variables for completeness and accuracy and found no missing or out of range values.

On the basis of our data reliability reviews of the five IRS databases, we believe all five contain data that are sufficiently reliable for the purposes of this report.

[5] GAO, *Tax Administration: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000*, GAO-04-358 (Washington, D.C.: Feb. 27, 2004). GAO, *International Taxation: Tax Haven Companies Were More Likely to Have a Tax Cost Advantage in Federal Contracting*, GAO-04-856 (Washington, D.C.: June 30, 2004).

Comments from the Internal Revenue Service

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

COMMISSIONER

September 24, 2004

Mr. Michael Brostek
Director, Tax Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Brostek:

I reviewed your draft report titled, *Tax Administration—IRS Should Take Steps to Improve the Accuracy of Schedule K-1 Data* (GAO-04-1040). We agree that improving the accuracy of taxpayer identification numbers (TINs) on Schedules K-1[1] will help us to better detect taxpayer non-compliance and that a pilot project would be useful in identifying ways to do so.

The complexity of this issue requires that we analyze a number of options to ensure we use the best methodology for TIN perfection. In fact, the issue of invalid TINs is currently being analyzed by the Flow-Through Compliance Committee (FTCC), which is composed of representatives from the Large and Mid-Size Business (LMSB) and Small Business/Self-Employed (SB/SE) Divisions. The FTCC's mission is to identify key risks associated with flow-through entities. It also serves as the focal point for the development of new tools and techniques for addressing flow-through issues. The committee recently initiated a project to explore issues related to invalid TINs on Schedules K-1. The project will involve studying a sample of schedules with invalid TINs to determine the potential compliance impact. As part of this study, we will also study options for perfecting TINs. We will weigh the cost of the options against the potential benefits and determine if a pilot program is appropriate.

We have already implemented several initiatives to enhance Schedule K-1 reporting compliance, including the redesign of forms and extensive outreach efforts. The form and instructions for the tax year 2003 Schedule E, *Supplemental Income*, contained enhancements designed to improve Schedule K-1 reporting accuracy. The redesigned Schedules K-1 for Partnerships and 'S' Corporations will be available for tax year 2004. In addition, a variety of communication efforts have taken place during the past two years to educate taxpayers and tax professionals on how to reduce errors in reporting income from flow-through entities.

[1] Partner's Share of Income, Credits, Deductions, etc. (Form 1065, Schedule K-1); Shareholder's Share of Income, Credits, Deductions, Etc. (Form 1120S, Schedule K-1); and Beneficiary's Share of Income, Deductions, Credits, etc. (Form 1041, Schedule K-1).

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Other actions we have taken include numerous enhancements to our matching program and the implementation of 2-D bar coding and Optical Character Recognition scanning to reduce transcription errors on paper schedules. All of these initiatives have helped to improve the overall effectiveness of our flow-through compliance efforts.

We will continue to seek additional ways to enhance the Schedule K-1 Program. If you have any questions, please contact Robert L. Hunt, Acting Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.

Sincerely,

Mark W. Everson

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