

January 2009

TAX GAP

IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements



GAO

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Highlights of [GAO-09-238](#), a report to the Committee on Finance, U.S. Senate

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IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements

Why GAO Did This Study

Third party payers, often businesses, reported \$6 trillion in miscellaneous income payments to IRS in tax year 2006 on Form 1099-MISC information returns. Payees are to report this income on their tax returns. Even a small share of payers failing to submit 1099-MISCs could result in billions of dollars of unreported payments. IRS data suggest that payees are more likely to report income on their tax returns if IRS receives payers' information returns.

GAO was asked to examine 1099-MISC reporting including the extent to which payers fail to submit 1099-MISCs; impediments to payers to submitting 1099-MISCs; and whether IRS could better use the 1099-MISCs it currently receives. GAO reviewed IRS documents and compliance data and interviewed officials from IRS, its advisory groups, and others who advise 1099-MISC payers.

What GAO Recommends

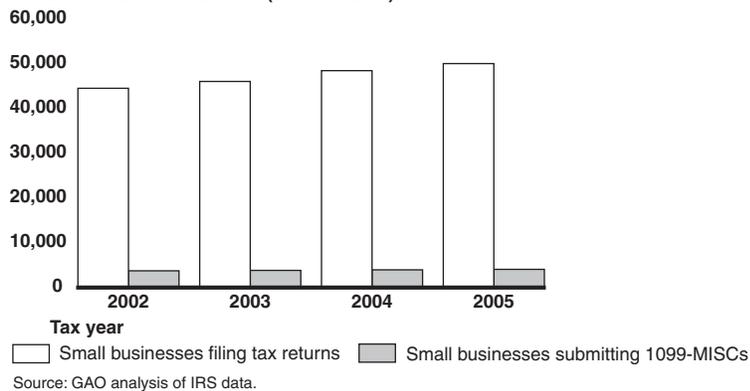
Congress should consider requiring payers to report payments to corporations on the Form 1099-MISC. GAO also makes eight recommendations to IRS, including researching the extent of and reasons for payer noncompliance; identifying common reporting errors; and providing more guidance about 1099-MISC requirements. IRS agreed with six of GAO's recommendations but disagreed with evaluating the checkbox option and adding a chart to the 1099-MISC instructions. GAO maintains its support for all recommendations.

To view the full product, including the scope and methodology, click on [GAO-09-238](#). For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

What GAO Found

The Internal Revenue Service (IRS) does not know to what extent payers fail to submit required 1099-MISCs, but various sources point to the possibility of a significant problem. For tax year 2005, 8 percent of the approximately 50 million small businesses with assets under \$10 million submitted 1099-MISCs, but IRS does not know how many of the other 92 percent were required to report payments but did not. Many business payments, such as payments to corporations, are not subject to 1099-MISC reporting. If even a small share of the businesses that did not submit a 1099-MISC should have, millions of 1099-MISCs could be missing with significant amounts of unpaid taxes by payees. GAO's prior work in 2003 found significant 1099-MISC payer noncompliance by some federal agencies. IRS could mitigate costs for research on payer noncompliance by building on its existing research programs.

Numbers of Small Businesses Filing Tax Returns and 1099-MISCs, Tax Years 2002 to 2005
Number of small businesses (in thousands)



Payers face a variety of impediments that may contribute to 1099-MISC noncompliance, including complex reporting requirements and an inconvenient submission process. For example, certain payments to unincorporated persons or businesses are subject to 1099-MISC reporting, but payments to corporations generally are not, requiring payers to determine the status of their payees. GAO in the past determined that the benefits in terms of increased tax revenue and improved taxpayer compliance justify eliminating this distinction. IRS agrees, and the Bush Administration's proposal to do so would have required legislative action. Other options to remind payers about their reporting obligations include adding a tax return checkbox asking if payers submitted required 1099-MISCs and adding a chart to help payers navigate the detailed instructions for the Form 1099-MISC.

IRS matches what the payees report on their tax returns to what payers report on 1099-MISCs to detect payees underreporting income and taxes. But IRS does not pursue all mismatches its computers detect. If IRS were to increase payer compliance with 1099-MISC requirements, the number of mismatches would likely increase. However, IRS does not systematically collect information on the causes of mismatches or whether they could be prevented.

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Abbreviations

AUR	Automated Underreporter Program
EIN	employer identification number
ETAAC	Electronic Tax Administration Advisory Committee
FIRE	Filing Information Returns Electronically
IRPAC	Information Reporting Program Advisory Committee
IRS	Internal Revenue Service
IRSAC	Internal Revenue Service Advisory Council
LMSB	Large and Mid-Size Business Division
NRP	National Research Program
PMF	Payer Master File
SB/SE	Small Business and Self-Employed Division
SOI	Statistics of Income
SCRIPS	Service Center Recognition Image Processing System
SSN	Social Security Number
TE/GE	Tax Exempt and Government Entities Division
TIGTA	Treasury Inspector General for Tax Administration
TIN	taxpayer identification number

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United States Government Accountability Office
Washington, DC 20548

January 28, 2009

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

For tax year 2006, third parties submitted more than 82 million miscellaneous income information forms (Form 1099-MISC) to the Internal Revenue Service (IRS) reporting more than \$6 trillion in payments. Third party payers are businesses, governmental units, and other organizations that make payments to other businesses or individuals. Payers must submit payment information on 1099-MISCs to IRS when they make a variety of payments labeled miscellaneous income.¹ Payees, or those being compensated, are required to report the payments on their income tax returns. By matching 1099-MISCs received from payers with what payees report on their tax returns, IRS can detect underreporting of income including failure to file a tax return.

Payer noncompliance with 1099-MISC reporting requirements undercuts IRS's ability to detect underreporting of income by payees and, as a consequence, contributes to the tax gap. This contribution may be large.² IRS has long recognized that if payments made to businesses are not reported on 1099-MISCs, it is less likely that they will be reported on payee tax returns. Based on IRS's most recent tax gap estimates, we reported that for tax year 2001 sole proprietors (individual owners of unincorporated businesses) understated their taxes by an estimated \$68 billion because of underreporting their net income.³ An unknown

¹See generally 26 U.S.C. §6041 and §6041A. §6041 requires information reporting for payments made in the course of a trade or business to another person such as for rent, salaries, compensation, etc. §6041A relates to returns regarding payments of remuneration for services and direct sales.

²The gross tax gap—\$345 billion in 2001 according to IRS's latest estimate—is the annual difference between what taxpayers should have paid and what they voluntarily paid on time. IRS estimated that it would eventually recover around \$55 billion of the 2001 tax gap through late payments and IRS enforcement actions, leaving a net tax gap of \$290 billion.

³GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, [GAO-07-1014](#) (Washington, D.C.: July 13, 2007).

proportion of this income could have been reported to IRS on 1099-MISCs but was not.

Other limited evidence also shows payer noncompliance with 1099-MISC reporting requirements. In 2003, we reported that some federal agencies failed to submit required 1099-MISCs covering billions of dollars of payments.⁴ A 2007 report by the Treasury Inspector General for Tax Administration (TIGTA) suggests that some state and local governments may also not be submitting required 1099-MISCs.⁵

Because of your concern about the tax gap, you asked us to study 1099-MISC reporting and whether IRS can make more use of 1099-MISC information that it already receives. Specifically, our objectives were to determine (1) what IRS knows about 1099-MISC reporting noncompliance by payers; (2) how IRS detects and pursues 1099-MISC reporting noncompliance by payers; (3) what impediments payers encounter in preparing and submitting accurate 1099-MISC forms, and what options could help IRS address these issues; and (4) what opportunities exist to enhance IRS's use of 1099-MISC information to detect payee noncompliance and promote voluntary taxpayer compliance.

To address these objectives, we reviewed IRS data, IRS documents, including advisory group reports; past GAO and TIGTA reports on 1099-MISC reporting compliance; IRS's procedures for checking compliance; and plans and proposals to expand 1099-MISC reporting. We also interviewed IRS officials and members of IRS advisory groups, tax professionals, and tax software and information return filing vendors to identify impediments facing payers in preparing and submitting 1099-MISCs. We interviewed IRS officials on the operations of the Automated Underreporter Program (AUR) which matches the payee's tax return against 1099-MISCs submitted by payers so that IRS can detect taxpayer underreporting; we reviewed AUR program data for tax year 2004 (the last full year available). We also analyzed data from the IRS's Payer Master File (PMF) and information reporting program data about 1099-MISCs submitted for tax year 2006. To obtain perspective on the potential

⁴GAO, *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns*, [GAO-04-74](#) (Washington, D.C.: Dec. 5, 2003).

⁵Treasury Inspector General for Tax Administration, *More Complete and Accurate Data are Needed to Assess the Impact of Actions to Address Compliance Reporting of State and Local Government Entities* (Reference No. 2007-10-081, June 8, 2007).

magnitude of payer noncompliance, we compared the aggregate numbers of small businesses filing tax returns with the numbers submitting 1099-MISCs for tax years 2002 to 2005.⁶ Using IRS's Statistics of Income data for tax year 2006, we estimated the 1099-MISC submission rate for a sample of Schedule C small businesses. We assessed the IRS data and found they were sufficiently reliable for the purposes of this report. We conducted this performance audit from June 2007 through January 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. (See app. I for more information on our scope and methodology.)

Results in Brief

IRS does not know the magnitude of 1099-MISC payer noncompliance or the characteristics of payers that fail to comply with the reporting requirements. Without an estimate of payer noncompliance, IRS has no way of determining to what extent 1099-MISC payer noncompliance creates a window of opportunity for payees to underreport their business income and go undetected by IRS. Available evidence points to the possibility of a significant problem with 1099-MISC payer noncompliance. Among small businesses (sole proprietors, and partnerships and corporations with assets under \$10 million), 8 percent of those filing tax returns also submitted 1099-MISCs for tax year 2005. For Schedule C small businesses that reported \$600 or more in contract labor expenses in 2006, we estimated that about 29 percent submitted 1099-MISCs, but we could not determine whether the other 71 percent were noncompliant given current reporting exemptions. The relatively small percentages submitting 1099-MISCs do not indicate that payers are not complying with 1099-MISCs reporting requirements, given the many exceptions that exempt payers from having to submit 1099-MISCs. However, IRS does not know how much of it may be because of payer noncompliance. Research about the extent of payer noncompliance could help IRS target outreach to payer groups and develop strategies to increase 1099-MISC reporting compliance. To mitigate costs, IRS could build on its existing research tools to study whether small businesses submitted their 1099-MISCs as required or identify reporting patterns using its payer history data.

⁶The last complete year of payer type data available for our analysis was tax year 2005.

IRS does not have an agencywide approach for detecting 1099-MISC payer noncompliance. For federal, state, and local government payers, examiners scrutinize information reporting compliance and identified over 30,000 missing 1099-MISCs totaling over \$522 million in payments for tax years 2005 through 2007. In response to our recommendation in 2003, IRS developed an automated “stop filer” program to notify federal agencies that submitted 1099-MISC one year but not the next. At this time, IRS does not generate notices for state and local entities that stop submitting 1099-MISCs and is working to update its payer history files for state and local governments. For business payers, examiners focus on income and employment tax liabilities that are likely to produce larger tax assessments than the penalties they would apply for missing 1099-MISCs. Further, examinations are costly and cover relatively few businesses each year, and thus would not be cost-effective as the sole means to address 1099-MISC reporting compliance. Yet, IRS does not have a systematic program in place to identify payers with gaps in their 1099-MISC reporting history or those that never submit the 1099-MISC forms. For example, IRS does not have any program for businesses similar to its federal stop filer program. Options for testing how to design a cost-effective stop filer notice program for businesses could include first checking to see whether a business filed a tax return before inquiring about 1099-MISCs or targeting notices to businesses reporting large contract labor expenses.

According to IRS, advisory group members, and others we interviewed, payers are confronted with a variety of impediments to preparing and submitting 1099-MISC forms, and some options could help promote voluntary reporting compliance by payers. Some payers that do not submit their 1099-MISCs as required may be unaware of their 1099-MISC reporting responsibilities. Other payers may be confused about whether payments are reportable because of different dollar reporting thresholds and the general exemption for payments to corporations. For the large number of payers each submitting a few 1099-MISCs, IRS does not offer a fillable form on its Web site and requires payers to submit scannable red ink forms, but some payers submit black and white 1099-MISCs anyway. Addressing payers’ concerns and making it easier to comply with 1099-MISC requirements could promote voluntary information reporting compliance. IRS could consider options, including those requiring legislative action, that it determines as cost efficient and would not impose undue burdens on payers or the agency itself. One option is removing the general exemption on reporting payments made to corporations, which would lessen the burden for payers of having to determine the payee business type and also provide information to help IRS detect underreported miscellaneous income. Since 1991, we have reported that

the benefits would exceed the cost for this approach. According to the Department of the Treasury's estimate, the Bush Administration's fiscal year 2009 proposal for reporting payments to corporations would generate about \$8.2 billion from 2009 through 2018, in part because of increased voluntary compliance. Other options involve adding a checkbox on tax returns attesting to the submission of 1099-MISCs as required and adding a chart to business tax instructions to help payers distinguish reportable from non-reportable payments, both of which could serve as reminders of 1099-MISC reporting responsibilities.

For tax year 2004 (the last full year available), the AUR program assessed \$972 million in additional taxes for payee underreporting detected using 1099-MISC information. The AUR program currently has a narrow reach and pursues less than half of 1099-MISC-related cases in the AUR inventory. To improve efficiency of the AUR program, IRS is rolling out a new "soft notice" contacting additional taxpayers in the AUR inventory and asking them to amend their returns to fix the underreporting. Soft notices may be a cost-effective way for IRS to expand its enforcement presence using 1099-MISC information, but it is too early to assess this new approach. Another way to free up AUR resources to work more cases is to reduce the number of unproductive cases that do not yield any additional tax revenue. In 2004, more than one-third of 1099-MISC cases selected for AUR review were manually screened out before taxpayer contact, and nearly one-quarter of those with taxpayer contact resulted in no tax change. Currently, IRS does not systematically collect information on the causes of unproductive AUR cases and had not conducted analyses to identify common 1099-MISC reporting errors. Such information could help IRS both to refine its AUR case selection and to target outreach helping payers and payees report 1099-MISC payments correctly.

We are suggesting that Congress consider amending the Internal Revenue Code to require third-party payers submit 1099-MISCs for service payments to corporations to reduce payers' burden to determine which payments require reporting. We are making several recommendations to IRS to help it identify the magnitude and characteristics of payers that do not comply with 1099-MISC reporting requirements and, using such research, to better detect and pursue payers failing to submit 1099-MISCs. Also, we are recommending ways that IRS can improve payer compliance with 1099-MISC reporting requirements, such as providing payers with a chart to identify reportable payments and exploring a new checkbox on business tax returns for payers to attest whether they submitted their 1099-MISC as required. We also recommend that IRS collect AUR case data on recurring reporting errors as a way to improve guidance and

outreach to help payers and payees more accurately report 1099-MISC payments.

In written comments on a draft of this report, IRS's Deputy Commissioner for Services and Enforcement agreed with six of our eight recommendations. However, IRS disagreed with our recommendation to assess whether adding a checkbox to business tax returns would increase 1099-MISC reporting compliance. IRS stated that a similar question was removed from the corporate tax return after the Paperwork Reduction Act of 1980 was enacted. We believe that the results from the evaluation we recommend could be useful to IRS in revisiting its 1981 assessment and weighing the benefits and burdens associated with the checkbox option. IRS also disagreed with our recommendation to include a chart in the 1099-MISC instructions and business income tax instructions. IRS stated that the Form 1099-MISC instructions already list which payments are reportable and explain the rules for specific payment types. We believe that a chart would provide taxpayers with a quick guide for navigating the eight pages of detailed instructions for the Form 1099-MISC. For this reason, we continue to recommend adding a chart to the 1099-MISC instructions and business tax instructions. IRS also provided technical comments that we incorporated as appropriate.

Background

Payers are required to submit 1099-MISCs for a variety of payments made in the course of a trade or business. For 1099-MISC reporting, a trade or business generally includes businesses, non-profit organizations, and federal, state, and local government agencies.

The types of payments reportable on a 1099-MISC and their reporting thresholds vary widely. These include payments to nonemployees for services of at least \$600 (called nonemployee compensation), royalty payments of \$10 or more, and medical and health care payments made to physicians or other suppliers (including payments by insurers) of \$600 or more.⁷ Personal payments, such as a payment by a homeowner to a contractor to paint his/her personal residence, are not reportable on a 1099-MISC. Other payments that are not reportable on a 1099-MISC generally include payments to a corporation, payments for merchandise,

⁷Some rent payments of at least \$600, other than those paid to real estate agents, are also reported on the 1099-MISC. Treasury Regulations §1.6041-3(d.). See GAO, *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, [GAO-08-956](#) (Washington, D.C.: Aug. 28, 2008).

and wages paid to employees. Wages paid to employees must be reported on a form W-2. There are many other types of payments that must be reported and numerous exceptions to these general rules. IRS provides eight pages of instructions detailing what payments to whom are reportable on the 1099-MISC.⁸ The form—shown in figure 1—consists of 14 boxes for reporting the various types of miscellaneous payments.⁹

⁸Internal Revenue Service, *2007 Instructions for Form 1099-MISC* (revised April 2007).

⁹Boxes 11 and 12 currently are not used to report payments.

For tax year 2006, more than 5 million payers submitted more than 82 million 1099-MISCs to IRS, reporting over \$6 trillion in payments. Nonemployee compensation payments totaled about \$2.3 trillion and accounted for about 55 percent of all 1099-MISCs submitted.¹⁰ Medical and health payments totaled about \$1.2 trillion and accounted for about 25 percent of all 1099-MISCs submitted. Each of the remaining payment types accounted for less than 10 percent of the number of 1099-MISCs submitted. Figure 2 shows the distribution of 1099-MISC payments types and amounts reported for tax year 2006.

¹⁰Nonemployee compensation is payment for labor or services to an individual a business does not officially employ. The nonemployee box also includes attorney fees paid to legal corporations as well as federal executive agency payments to corporate vendors.

Figure 2: Numbers of 1099-MISC Payments by Type and Total Amounts Reported by Payers to IRS, Tax Year 2006



Source: IRS.

Note: Data are from IRS's Information Returns Master File. The numbers of 1099-MISC payments reported do not total to the number of 1099-MISCs submitted by payers because a single 1099-MISC may report more than one payment.

^aNonemployee compensation and medical payments include payments to corporations.

^bSection 409A refers to the section in the Internal Revenue Code specifying the tax treatment for nonqualified deferred compensation plans. Qualified deferred compensation plans like pensions, retirement plans, and stock options are taxed at the time the individual actually receives the income. The amount reported as Section 409A income is also reported as nonemployee compensation.

In addition to the 8 pages of instructions for 1099-MISC reporting, IRS also has 19 pages of general instructions for third-party information reporting, detailing how and when payers are to submit 1099-MISCs to payees and IRS.¹¹ Payers must provide 1099-MISC statements to payees by the end of January. Payers submitting fewer than 250 1099-MISCs may submit paper

¹¹Internal Revenue Service, *General Instructions for Filing Forms 1098, 1099, 5498, and W-2G, 2007*.

forms, which are due to IRS by the end of February, along with a Form 1096, Annual Summary and Transmittal of U.S. Information Returns. Payers submitting paper 1099-MISC are required to use IRS's official forms or substitute forms with special red ink readable by IRS's scanning equipment.¹² Photocopies and copies of the 1099-MISC form downloaded from the internet or generated from software packages in black ink do not conform to IRS processing specifications.

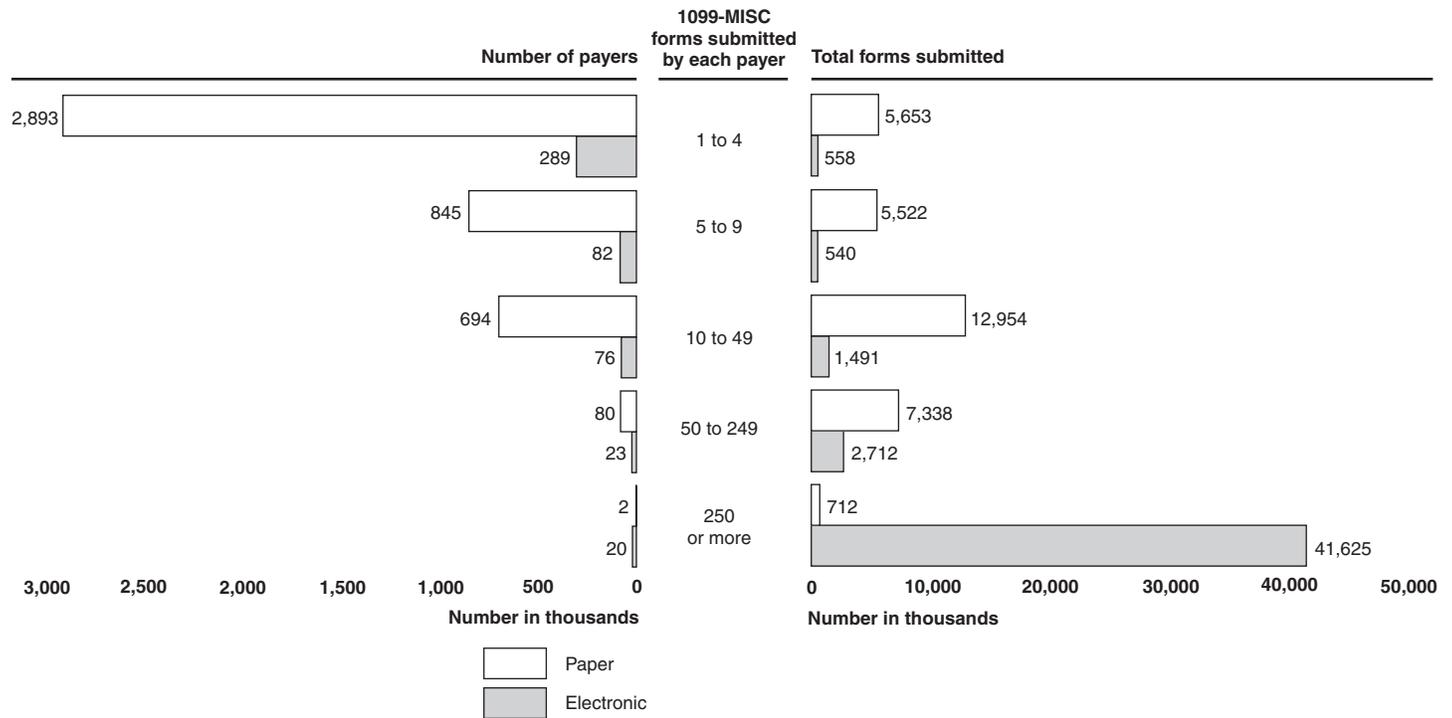
Payers submitting 250 or more 1099-MISCs are required to submit the forms magnetically or electronically.¹³ Electronic submissions due at the end of March can be submitted through IRS's Filing Information Returns Electronically (FIRE) system. As shown in figure 3, most 1099-MISCs for tax year 2006 were submitted electronically.¹⁴ However, most payers submit small numbers of 1099-MISCs, and most payers submitted paper 1099-MISCs.

¹²IRS uses the Service Center Recognition Image Processing System (SCRIPS) to capture printed or handwritten information from paper forms and convert the information into machine-readable format for computer processing.

¹³26 U.S.C. § 6011(e)(2)(A).

¹⁴Figure 3 does not include data for magnetic submissions. IRS is phasing out magnetic submissions after December 31, 2008. See Internal Revenue Service, *Publication 1220 Specifications for Filing Forms 1098, 1099, 5498, and W-2G Electronically* (June 9, 2008).

Figure 3: Paper and Electronic Submissions by Payer Categories, Tax Year 2006



Source: IRS data.

Note: Payers could submit in more than one media. Numbers have been rounded and may not total correctly. The threshold mandated for electronic submissions is 250 forms.

IRS's four business operating divisions are generally responsible for ensuring payers comply with their 1099-MISC reporting requirements. The Wage & Investment Division, Tax Exempt and Government Entities Division (TE/GE), Large and Mid-Size Business Division (LMSB), and Small Business and Self-Employed Division (SB/SE), as a part of their duties, conduct examinations of tax returns and documents to verify compliance with tax laws. Examinations can include checking payer compliance with 1099-MISC reporting requirements.¹⁵

¹⁵IRS generally defines large and mid-size corporations and partnerships as those with assets over \$10 million. Small businesses are those with assets under \$10 million, including sole proprietorships.

IRS can penalize payers for failing to submit or submitting an inaccurate 1099-MISC.¹⁶ The penalty is generally \$50 per information return, increasing to \$100 each for intentional payer noncompliance of 1099-MISC requirements.¹⁷ To encourage voluntary reporting compliance, the penalty is \$15 (up to a maximum of \$75,000 per calendar year or \$25,000 for small businesses) if the 1099-MISC is submitted within 30 days of the due date; \$30 (up to a \$150,000 maximum per calendar year or \$50,000 for small businesses) if submitted after 30 days but by August 1, and \$50 (up to a maximum of \$250,000 per calendar year or \$100,000 for small businesses) if submitted after August 1 or not at all. IRS will waive the penalty if the payer can show “reasonable cause” or if the error or omission does not prevent or hinder the IRS from processing the 1099-MISC.¹⁸ In IRS’s fiscal year 2009 budget proposal, the Bush Administration proposed increasing the \$50 and \$100 penalties to \$100 and \$250 respectively for each information return.¹⁹ In 2007, we suggested that Congress consider requiring IRS to periodically adjust penalties for inflation, and round appropriately, the fixed dollar amounts of civil tax penalties to account for the decrease in real value over time and so that penalties for the same infraction are consistent over time.²⁰

Payees are responsible for reporting payments they received from payers on the appropriate lines of their tax returns.²¹ Payees are also responsible for paying self-employment taxes if they received nonemployee compensation. For example, a sole proprietor receiving a 1099-MISC for nonemployee compensation is to report the payments on Schedule C of the 1040 tax return and file Schedule SE to pay the associated self-employment taxes. Sole proprietor payees are supposed to report 1099-

¹⁶26 U.S.C. § 6721.

¹⁷26 U.S.C. § 6721 provides for lower maximum penalties for small businesses with average annual gross receipts of \$5 million or less for the 3 most recent tax years (or for the period in existence if shorter) ending before the calendar year in which the information returns were due.

¹⁸26 U.S.C. § 6724.

¹⁹The administration estimated that this proposal would generate \$391 million over the next ten years.

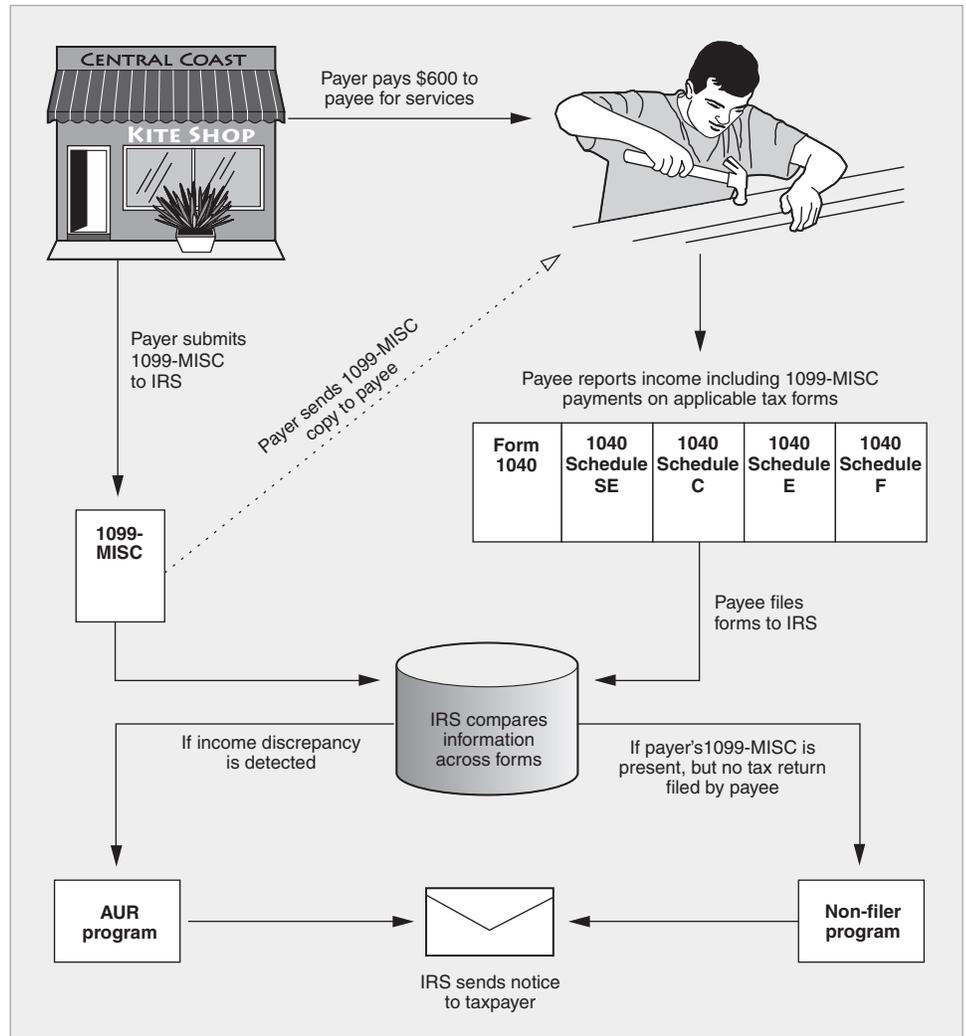
²⁰GAO, *Tax Compliance: Inflation Has Significantly Decreased the Real Value of Some Penalties*, [GAO-07-1062](#) (Washington, D.C.: Aug. 23, 2007).

²¹Payments that are not reportable on 1099-MISC may, nonetheless, be taxable to the payee, and payees must report all income to IRS on their income tax returns.

MISC payments as gross receipts and separately report their expenses rather than reporting only net amounts.

Figure 4 shows the automated process IRS uses to detect mismatches between nonemployee compensation and other payments reported on 1099-MISCs and payees' income tax returns. The Nonfiler program handles cases where no income tax return was filed by a 1099-MISC payee. The Automated Underreporter (AUR) program handles cases where a payee filed a tax return but underreported 1099-MISC payments. AUR's case inventory includes payee mismatches over a certain threshold, and IRS has a methodology using historical data to select cases for review. AUR reviewers manually screen the selected cases to determine whether the discrepancy can be resolved without taxpayer contact. For the remaining cases selected, IRS sends notices asking the payee to explain discrepancies or pay any additional taxes assessed.

Figure 4: Matching 1099-MISC Reportable Nonemployee Compensation Information with Individual Tax Returns



Source: GAO analysis of IRS information.

According to IRS, third-party information reporting increases voluntary tax compliance in part because taxpayers know that IRS is aware of their income. For wages and salaries subject to tax withholding and substantial third-party information reporting, the percentage of income that taxpayers misreport has consistently been measured at around 1 percent. In contrast, for non-farm sole proprietor income subject to little or no third-party

reporting, taxpayers misreported more than half of such income in 2001, according to IRS's most recent tax gap estimates.

IRS Has Little Information about 1099-MISC Reporting Compliance, but Available Evidence Points to the Possibility of a Significant Problem

IRS does not have an estimate of 1099-MISC reporting compliance or know the characteristics of those payers that fail to comply with the reporting requirements. Without an estimate of payers' 1099-MISC noncompliance, IRS does not know to what extent such noncompliance allows payees to underreport their income without being detected. If a large number of payers fail to submit required 1099-MISCs, then the resulting decrease in payee tax compliance and lost revenue could be large. According to IRS, it is a common misconception among payees that they are not required to report payments if they have not received a 1099-MISC from payers.²²

IRS has invested significant resources in measuring compliance with other aspects of the tax laws. For example, the National Research Program (NRP) estimated the compliance rate for individual taxpayers for tax year 2001 based on an intensive review of a sample of 46,000 tax returns. IRS is in the process of completing a new study of the rate of tax compliance by individual taxpayers for tax years 2006 and 2007, and is conducting a similar study of S-corporations.²³ IRS uses such research to understand where compliance problems are greatest and to understand the sources of noncompliance. Armed with such understanding, IRS can make better decisions about where and how to deploy its resources to address noncompliance.

²²Internal Revenue Service, "Reporting Miscellaneous Income" Fact Sheet, FS-2007-26, November 2007.

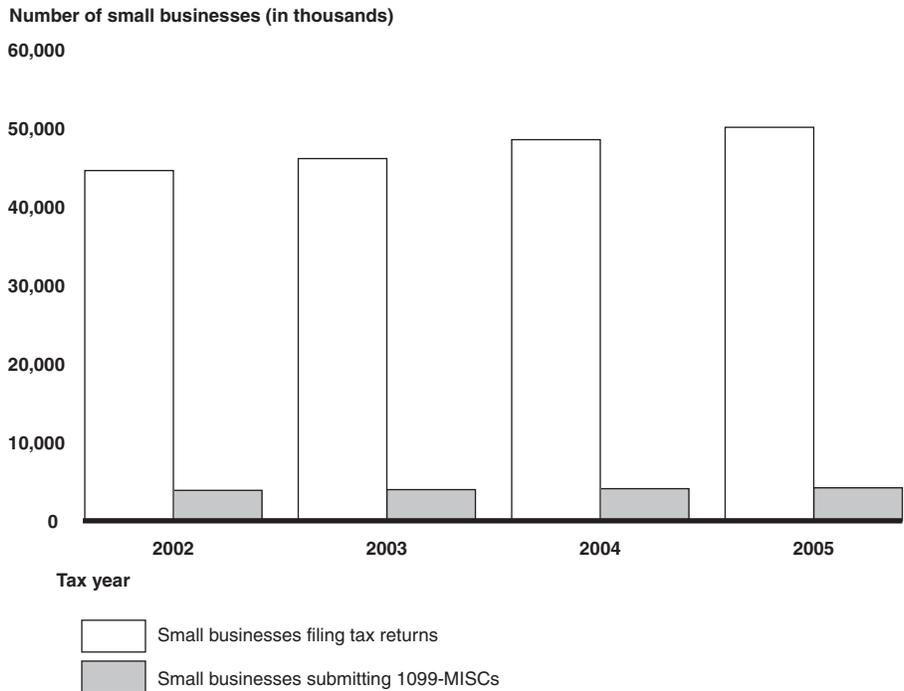
²³An S-corporation is a corporation with a limited number of shareholders (100 or fewer) that is not taxed as a regular corporation and meets certain other requirements. According to IRS, this is the most common corporate entity.

Although IRS Does Not Know the Extent of 1099-MISC Payer Noncompliance, Available Evidence Points to the Possibility of a Significant Problem

Our analysis of 1099-MISC submission patterns by small businesses as well as past studies of federal, state and local government agencies suggests that payer noncompliance with 1099-MISC reporting requirements may be potentially significant. Our analysis of IRS's PMF data for tax year 2005 (the last complete year available) showed that, in aggregate, 8 percent of small businesses (sole proprietorships, and corporations and partnerships with assets under \$10 million) submitted a 1099-MISC.²⁴ As shown in figure 5, over 4 million small businesses submitted 1099-MISCs in tax year 2005, and in comparison, 50 million small businesses filed income tax returns with IRS that same year. Results were similar for the three previous years.

²⁴Even among the 8 percent submitting 1099-MISCs, some small business payers submitted their 1099-MISCs late or missing key payee information, and some may have failed to submit 1099-MISCs for some reportable payments. Below we discuss impediments facing payers in preparing and submitting Form 1099-MISCs to IRS.

Figure 5: Aggregate Comparison of the Number of Small Businesses Filing Tax Returns and Number of Small Businesses Submitting 1099-MISCs, Tax Years 2002 to 2005



Source: GAO analysis of IRS data.

Note: IRS defines small businesses, including sole proprietorships, partnerships, and corporations, as entities with assets under \$10 million. The number of small business entities filing a tax return with IRS came from IRS's Business Master File and Individual Master File; the number of small businesses submitting 1099-MISCs came from IRS's Payer Master File.

The fact that a relatively low percentage of small businesses submitted a 1099-MISC does not indicate on its own that there is a significant payer noncompliance problem.²⁵ The many exceptions to the general rules for submitting 1099-MISCs along with the payment thresholds mean that many small businesses may not be required to submit a 1099-MISC. However, if even a small proportion of the almost 46 million small businesses that did not submit 1099-MISCs in 2005 improperly failed to report as required, there could be millions of missing 1099-MISC information reports. As a consequence, payees could have less incentive to voluntarily report that

²⁵The difference between large businesses filing tax returns and submitting 1099-MISCs is much smaller as large businesses may file consolidated income tax returns while submitting information returns under individual subsidiaries.

1099-MISC income on their own tax returns if they did not receive a 1099-MISC from the payer, and IRS would be unable to detect payee underreporting through document matching. Yet, IRS has no idea of the magnitude of payer noncompliance and thus the amount of missing 1099-MISCs, as discussed above.

As a proxy for a possible 1099-MISC reporting requirement, we examined the 1099-MISC submission rate for Schedule C small businesses that reported amounts of \$600 or more in contract labor expenses.²⁶ Based on IRS's Statistics of Income (SOI) data for tax year 2006, about 29 percent of Schedule C filers reporting contract labor expenses of \$600 or more submitted 1099-MISCs.²⁷ Again, we could not determine whether the other 71 percent of Schedule C filers reporting contact labor expenses over the 1099-MISC reporting threshold were noncompliant. Some payers may have amounts under the reporting threshold to multiple payees, and other payers may have paid corporate payees currently exempt from 1099-MISC reporting. However, some payers may have failed to submit 1099-MISCs as required, and IRS does not have data to estimate how often this occurs.

Our 2003 assessment of federal agency compliance with 1099-MISC reporting requirements did find significant payer noncompliance.²⁸ While most federal agencies in the 14 departments we studied submitted information returns as required for calendar years 2000 and 2001, there were some significant exceptions. Three federal departments—Agriculture, Commerce and Justice—collectively made \$5 billion in payments to 152,000 payees in 2000 and 2001 but did not report the payments to IRS on Form 1099-MISCs. In turn, about 8,800 of the payees who collectively received payments totaling about \$421 million dollars—an average of about \$48,000 each—did not file income tax returns for those 2 years.²⁹

²⁶Beginning in tax year 2007, IRS instructions specify that expenses reported on the Schedule C contract labor line may be reportable on the 1099-MISC.

²⁷For the SOI sample estimate of 28.9 percent, we are 95 percent confident that the actual estimate is between 27.3 and 30.5 percent.

²⁸[GAO-04-74](#).

²⁹At the time, IRS did not have a program to identify and follow-up with federal agencies that did not submit information returns. IRS activities to monitor federal compliance with 1099-MISC reporting requirements in response to our 2003 recommendations are discussed later in this section.

In June 2007, TIGTA reported that trends in 1099-MISC reporting by state and local governments demonstrated potential payer noncompliance for tax years 2003 through 2005. For example, while TIGTA found that over half of the 81,000 state and local government entities submitted 1099-MISC forms for each of the 3 years, 30 percent did not submit any 1099-MISC forms over the period.³⁰ As of December 2008, IRS had research planned for fiscal year 2009 to determine whether state and local governments that did not submit any 1099-MISCs for tax years 2003 through 2005 were noncompliant and reasons why they did not report.

Research about Payers' Noncompliance with 1099-MISC Reporting Requirements Could Help IRS Target Efforts to Increase Payer Voluntary Reporting Compliance

Research about the extent and causes of payer noncompliance could help IRS develop more effective strategies to increase 1099-MISC submissions. Such research would involve costs, but there are options for mitigating the costs. IRS might be able to build on current research efforts, such as the NRP, or use existing data from the Payer Master File.

Because NRP is already collecting detailed information about small business compliance with the rules for reporting receipts and expenses, the design of the NRP could be tailored at a relatively low cost to assess the extent to which these small businesses submitted 1099-MISCs as required.

In the 2006 and 2007 NRP, IRS is studying whether payers that submitted 1099-MISCs correctly classified the payees as nonemployees. By misclassifying employees as nonemployees, employers could avoid withholding taxes as well as paying employment taxes. The 2006 NRP used a supplemental questionnaire to collect information on 1099-MISC payer reporting for use in assessing misclassification issues. The 2007 NRP procedures will direct NRP examiners to more systematically capture data about whether small business payers in the NRP sample were required to submit information returns—including 1099-MISCs—but did not. At this

³⁰Government audits, such as in New York City and Detroit, confirm that some local agencies did not always report 1099-MISCs as required. City of New York, Office of the Comptroller, *Audit Report: Follow-up Audit on the Financial and Operating Practices of the Queens County Public Administrator, MD06-057F*, April 24, 2006; and City of Detroit, Office of the Auditor General, *Follow-up Audit of the Law Department*, July 2005-June 2007.

time, IRS has not studied the extent to which payers failed to submit 1099-MISCs, but the future NRP results could be useful for this purpose.³¹

Another option IRS could explore at a relatively low cost is using PMF data to identify businesses that stop reporting or never report 1099-MISCs. The PMF data set was used by TIGTA and us in detecting whether federal, state, and local governments reported 1099-MISCs. In turn, IRS used PMF data to select a sample of state and local governments that did not submit any 1099-MISCs for a compliance research project planned for fiscal year 2009. To explore small business payer noncompliance, IRS could use the PMF data to identify those businesses that submitted 1099-MISCs in past years but stopped reporting. IRS also could compare the PMF population to its master file to identify small businesses that never submitted 1099-MISCs, and subsequently conduct research to audit a sample of the population to determine whether those not submitting 1099-MISCs should have. From this type of research, IRS could decide how to target particular segments of the payer population (e.g., Schedule C filers that report contract labor expenses over \$600 or more but do not submit 1099-MISCs) for more education and outreach in order to reduce payer noncompliance.

Benefits of 1099-MISC payer compliance research could be significant. For perspective, payers reported \$6 trillion in 1099-MISC payments for tax year 2006, so a one percent increase in reported payments could result in an additional \$60 billion reported to payees and IRS.

IRS Efforts to Detect Payers That Fail to Submit 1099-MISC Forms Are Uneven

Within IRS, TE/GE is active in detecting and pursuing 1099-MISC payer noncompliance among federal, state, and local agencies in part so that government contractors and vendors cannot evade their tax liabilities.³² A TE/GE official said that the division's focus is on employer quarterly returns that governmental entities file, as opposed to annual income tax returns that the other business divisions examine. According to IRS officials, as a part of this resource-intensive focus on quarterly returns,

³¹NRP data with 2006 and 2007 results will be available in late 2009 and late 2010, respectively.

³²IRS can check for payer compliance with 1099-MISC reporting requirements through examinations and voluntary compliance checks. An examination may involve an in-depth review of an entity's tax records, and identifying tax discrepancies or an additional tax liability. A compliance check involves contact with the entity or individual, but is more limited in its scope, because it does not involve determining a tax liability. An entity has the right to decline to participate in a compliance check.

TE/GE examiners also scrutinize information returns, including 1099-MISCs, that governmental entities file. To illustrate the impact that TE/GE's efforts had on detecting noncompliance among government payers, IRS audit specialists identified and secured over 30,000 additional 1099-MISCs totaling over \$522 million in payments that governmental entities made to payees for tax years 2005 through 2007.

According to IRS officials, TE/GE implemented a "stop filer" program in response to our 2003 recommendation that IRS develop a mechanism for identifying and tracking federal agencies that fail to submit Form 1099-MISCs.³³ This automated stop filer notice program, which is a minimal cost approach compared to other enforcement options for detecting possible payer noncompliance, was developed for federal agencies that submitted 1099-MISCs one year but not the next. Using PMF data, TE/GE issues IRS form 3939 to a federal agency that stops submitting 1099-MISCs, asking the agency to provide an explanation. TE/GE officials said they sent over 1,100 stop filer notices for tax year 2006 to federal entities in August 2008. The officials also said the federal agencies' responses to these notices are useful to TE/GE in selecting federal agencies for voluntary compliance checks or examinations. Servicewide, IRS also uses PMF data to identify payers that submit 1099-MISCs late or with missing tax identification numbers (TINs). However, IRS does not systematically use the database to identify payers with gaps in 1099-MISC reporting history or those that never submit the 1099-MISC forms.

At the time of our review, TE/GE officials stated that numerous discrepancies exist in the PMF with the coding for state and local governments, and the division is working to correct them. For fiscal year 2009, TE/GE plans a 1099-MISC compliance check for a random sample of 200 state and local governments that did not submit 1099-MISCs for tax years 2003 through 2005.³⁴ Once they have completed this activity, they will determine whether sending notices to state and local governmental agencies to check for payer noncompliance with 1099-MISC reporting requirements is an option they should pursue.

³³In [GAO-04-74](#), we found that IRS did not have a mechanism for identifying and tracking federal agencies that failed to file Forms 1099-MISCs for vendor payments. One of our recommendations was that IRS establish such a program.

³⁴The sample was selected from over 23,000 state and local agencies which were identified by TIGTA as not submitting any 1099-MISCs and not subject to any previous compliance check by TE/GE.

Another low cost approach that TE/GE officials used is to compile a listing of common 1099-MISC payer compliance problems drawn from information obtained through examinations and compliance checks. For example, government payers sometimes fail to report all payments, or submit 1099-MISCs late or with missing payee information. According to TE/GE officials we interviewed, their list of common 1099-MISC reporting errors is used both to educate examiners on what to look for during examinations and reach out to government agencies to help them better comply.

For business taxpayers, IRS policy instructs SB/SE and LMSB examiners to determine whether all information returns, including 1099-MISCs, are submitted as required and consider internal controls for information return reporting. LMSB examiners are to conduct risk analyses of tax returns to identify potential noncompliance issues as part of the audit planning process. As a result of the risk analysis and in contrast with SB/SE practices, LMSB examiners can waive the compliance checks for LMSB taxpayers to ensure efficient and effective use of resources.

Where an examination identifies that a business failed to comply with its requirement to submit information returns, including Form 1099-MISC, the examiner is to secure the missing information returns. IRS could not provide data on how many business examinations detected payers that failed to submit 1099-MISCs or how many missing 1099-MISCs have been secured by LMSB and SB/SE examiners. While examinations primarily focus on income and employment tax liabilities for business payers, the examiner also is to consider whether to pursue information return penalties depending on the facts and circumstances of the case. Improved voluntary compliance by the payer and its payees may justify the expenditure of time required to track down the missing 1099-MISCs and assess the penalties. However, the maximum penalty is \$50 for unintentional payer noncompliance and \$100 for intentional noncompliance for each additional 1099-MISC collected.³⁵ IRS has proposed increasing information return penalties to \$100 and \$250, respectively.

Further, examinations have limitations in that they are costly and cover relatively few businesses each year, and thus would not necessarily be

³⁵If a payer submitted 1099-MISCs with missing TINS and was previously directed by IRS to begin backup withholding for the payees without TINS, the payer can be held liable for amounts of backup withholding not withheld from those payees.

cost-effective as the sole means to address 1099-MISC payer reporting compliance. For example, IRS data show that IRS examinations covered less than 1 percent of the 2.2 million tax returns that small corporations filed for fiscal year 2007. As we previously reported, IRS examined about 3 percent of Schedule C returns in fiscal year 2006.³⁶

Beyond conducting examinations, which we have described as having limitations, IRS does not have an agencywide approach in place to identify payers that do not submit 1099-MISC forms. More specifically, IRS does not have a stop filer notice program for businesses, as it does for federal agencies, to detect 1099-MISC reporting gaps. In contrast with the relatively small and stable populations of federal, state, and local government payers, the large and shifting population of small businesses might challenge IRS in designing a cost-effective method for isolating and contacting business payers that do not submit 1099-MISCs. Given that new businesses start each year while others stop operating or merge with other businesses, one approach would be to first check to see whether a business filed a tax return before sending any notice inquiring about 1099-MISC reporting. While notices are likely to provide a more cost-effective approach for pursuing possible payer noncompliance compared to examinations, it would be important for IRS to test a stop filer program to determine how to target notices to businesses. For Schedule C filers for example, a notice program could target payers that reported large contract labor expenses but did not submit 1099-MISCs.³⁷ Without testing the viability of a broader stop filer notice program, IRS could be overlooking a useful tool that would help increase 1099-MISC payer compliance.

³⁶[GAO-07-1014](#).

³⁷Whereas the SOI sample dataset we used in our Schedule C analysis included contract labor expense information, IRS currently does not transcribe the contract labor expense line for all Schedule Cs filed.

Payers Face Impediments in Preparing and Submitting 1099-MISCs, and Some Options Could Help Promote Voluntary Reporting Compliance by Payers

According to IRS officials, IRS advisory groups, and members of the 1099-MISC community we interviewed, a variety of impediments inhibit 1099-MISC reporting compliance.³⁸ As a result, some payers report erroneous information or fail to submit all 1099-MISCs as required. Some payers that do not submit their 1099-MISCs as required may be unaware of their 1099-MISC reporting responsibilities. Other payers may be confused by various aspects of the 1099-MISC requirements. Finally, the inconvenience of submitting 1099-MISCs—whether on paper forms or electronically—may deter compliance. While the extent to which these impediments contribute to payer noncompliance is unknown, interviewees and others identified options for addressing them to promote voluntary compliance.

Table 1 highlights options based on our analysis and includes options we previously reported. We note those options that were proposed by IRS, IRS advisory groups, and the National Taxpayer Advocate.³⁹ Our list of 1099-MISC impediments and options is not exhaustive, nor is the list of pros and cons associated with the options. Improved IRS guidance and education are relatively low-cost options, but most taxpayers use either tax preparers or tax software to prepare their tax returns, and may not read IRS instructions and guidance. While taxpayer service options may improve compliance for those that are inadvertently noncompliant, they are not likely to affect those that are intentionally noncompliant.⁴⁰ Some options to change 1099-MISC reporting requirements require legislative action, and other options would be costly for IRS to implement. Where the option involves particular issues, such as cost or taxpayer burden, we note them in our table.

³⁸IRS advisory groups include Electronic Tax Administration Advisory Committee (ETAAC), Information Reporting Program Advisory Committee (IRPAC), and Internal Revenue Service Advisory Council (IRSAC). We also interviewed tax professionals, tax software vendors, paid preparers, and other business and professional association representatives knowledgeable about 1099-MISC payer reporting attending the IRS National Public Liaisons (NPL) fall 2007 meeting.

³⁹The table notes options specifically recommended by IRS's advisory groups or by IRS in its budgets and tax gap plans.

⁴⁰GAO, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential*, [GAO-08-703SP](#) (Washington, D.C.: June 2008).

Table 1: Impediments to 1099-MISC Payer Reporting Compliance and Options for Increasing Voluntary 1099-MISC Compliance

Impediments facing 1099-MISC payers	Options for increasing voluntary compliance and related pros and cons
Some payers are unaware of their 1099-MISC reporting responsibilities	
1. Some payers are unaware of their 1099-MISC reporting responsibilities.	<ul style="list-style-type: none"> • Add general reminder to <i>Publication 535 Business Expenses</i> to highlight 1099-MISC reporting responsibilities. • Revise business tax form instructions to remind taxpayers of 1099-MISC reporting requirements for specific expense types. <ul style="list-style-type: none"> • IRS added a 1099-MISC reminder to the 2007 Schedule C instructions for contract labor expenses, and such reminders can be added for other 1099-MISC reportable expenses such as rent and legal and professional services. • Target 1099-MISC related education and outreach activities to specific payer groups (IRSAC, 2005; IRS Oversight Board, 2008).^a <ul style="list-style-type: none"> • IRS has initiated such outreach to federal, state, local and tribal governments, but more research is needed to determine which business payer groups to target. <p>All of the above may be of limited efficacy if taxpayers rely on paid preparers and tax preparation software and do not look at IRS instructions or guidance, or if taxpayers are willfully misreporting. Providing additional guidance could be helpful if tax return preparation software is based on the guidance.</p> <ul style="list-style-type: none"> • Increase outreach to paid preparers and tax software vendors to promote awareness of 1099-MISC reporting responsibilities (IRSAC, 2005). <ul style="list-style-type: none"> • Providing 1099-MISC training outreach through IRS's phone forums or Nationwide Tax Forums can reach large numbers of paid preparers. • Many payers rely on paid preparers and tax software to help them comply with their reporting responsibilities. • Add check-the-box question to business tax forms requiring taxpayers to attest whether they submitted 1099-MISCs related to their reported expenses (IRSAC, 2005; National Taxpayer Advocate, 2005). <ul style="list-style-type: none"> • Would force tax preparers and tax software to query taxpayers about their expenses, and taxpayers would have to respond to the checkbox under penalty of perjury. • According to the National Taxpayer Advocate, the burden associated with a checkbox asking taxpayers to verify that they have complied with existing legal requirements is inherently small. • Impact may be on increasing voluntary compliance, with little utility as an IRS enforcement tool. • California has a similar checkbox on state corporation and S-corporation income tax returns, which serves as a reminder to taxpayers, as shown below in figure 6. California has not evaluated how this reporting feature affects payer reporting compliance. <hr/> <ul style="list-style-type: none"> • Add a chart in the business income tax instructions to help payers determine if they have a potential 1099-MISC reporting requirement and need to review the 1099-MISC instructions. IRS frequently provides charts and worksheets to help taxpayers understand their filing obligations.^b

Impediments facing 1099-MISC payers

2. Some payers first learn about 1099-MISC reporting responsibilities from their tax preparers after 1099-MISC due dates have passed.

Options for increasing voluntary compliance and related pros and cons

- Add IRS's "Information Returns Processing" hyperlink to its "Starting a Business" and "Small Business and Self-Employed Tax Center" sites to make information reporting a more prominent aspect of business responsibilities.
- Provide a general notice about 1099-MISC reporting responsibilities to new small business owners when they apply for an employer identification number (EIN).
 - IRS currently encourages online application and provides EINs immediately after validation which makes this a low cost option.
- Provide a notice about 1099-MISC reporting responsibilities, key requirements, and due dates to small businesses each fall. Notices could be sent to some businesses, such as Schedule C filers reporting contract labor expenses for the first time, or all small businesses.
 - Potentially costly mailing. May not be cost-effective if large numbers of businesses do not have 1099-MISC reportable payments.
- Have single due date for 1099-MISC submission to IRS.
 - Change paper submission due date to IRS from February 28 to March 31 to encourage taxpayers and tax preparers to prepare any 1099-MISCs that may have been overlooked without fear of penalty (IRSAC, 2005).
 - Change electronic submission due date to IRS from March 31 to February 28 to allow IRS more time to process 1099-MISC for computer matching (Electronic Tax Administration Advisory Committee (ETAAC), 2006).
 - Changing due dates for submitting 1099-MISC to IRS affects due dates for other information return series, but does not change the January due date to payees.
- Waive late submission penalties for first-time payers.
 - Some payers that realize they are late in submitting 1099-MISCs may choose not to file rather than run the risk of incurring late penalties. IRS already reduces the late penalty for 1099-MISCs submitted before August 1 to encourage voluntary submissions.
 - Hard for IRS to distinguish first-time payers that may have reasonable cause for being late from payers that have willfully neglected submit 1099-MISCs. Thus, this option may require legislative action to grant IRS authority to automatically waive the late penalty for 1099-MISC payers reporting for the first time.

Some payers are confused about 1099-MISC requirements

1. Payers must navigate through 8 pages of singled-spaced instructions to determine what to report in the 14 boxes on the 1099-MISC.

- Add a chart in the 1099-MISC instructions for distinguishing 1099-MISC reportable from non-reportable payments and for calculating whether reportable payments reached reporting threshold. For example, IRS *General Instructions for Forms 1099, 1098, 5498 and W-2g* contain a chart highlighting what payments and amounts to report for various information returns, including Form 1099-MISC.
- Clarify guidance to address common misreporting errors.
 - IRS does not have research identifying the reasons for payer reporting problems

Impediments facing 1099-MISC payers**Options for increasing voluntary compliance and related pros and cons**

- | | |
|--|---|
| 2. Payers must determine whether payee is a corporation that is exempt from 1099-MISC reporting. | <ul style="list-style-type: none">• Change legislation to extend reporting requirements to include payments to corporations. We previously reported that the benefits in terms of increased revenue and taxpayer compliance exceed costs. In 1991, we suggested that Congress needed to enact legislation to require reporting on payments to corporations but did not formally recommend that matter for congressional consideration.^c IRS agrees that the benefits of this option in addressing the tax gap outweigh the costs. The Bush Administration requested legislative action in its fiscal year 2008 and 2009 budgets. According to Treasury estimates, this proposal would generate \$8.2 billion from 2009 through 2018, due in part to increased voluntary compliance and IRS's ability to detect underreported payments received by businesses.^d• The burden of determining the payee's status would be simplified. Some payers already submit 1099-MISC for all corporate payees rather than determine payee status. (IRSAC, 2005). However, other payers fail to submit 1099-MISCs currently required because they mistake small business payees as corporations exempt from reporting.• Payers need to submit more 1099-MISCs (IRPAC, 2007). Various phase-in options could minimize the burden and disruption for payers, such as delaying the effective date or initially covering only specific payment types, such as rent payments to corporations.^e |
| 3. Payers must determine whether payments are reportable due to different reporting thresholds. Some payers may underreport miscellaneous income types, such as royalties, with thresholds lower than \$600. | <ul style="list-style-type: none">• Add a chart in the 1099-MISC instructions for distinguishing 1099-MISC reportable from non-reportable payments and for identifying whether reportable payments reached reporting threshold. Similarly, adding a chart in the business income tax instructions could help payers determine if they have a potential 1099-MISC submission requirement and need to review the full instructions.• Standardize or eliminate dollar threshold for reporting payments (NTA, 2005; IRPAC, 2006).^f<ul style="list-style-type: none">• Lower uniform amount (National Taxpayer Advocate, 2005).<ul style="list-style-type: none">• Increased payer burden to submit more 1099-MISCs.• Increased number of 1099-MISCs to IRS for detecting payee income underreporting.• Higher uniform amount<ul style="list-style-type: none">• Decreased payer burden.• Decreased number of 1099-MISCs to IRS for detecting payee income underreporting.• Some options to change the dollar reporting threshold require legislative action. |
| 4. Some payers overlook reporting payments for non-routine or sporadic one-time transactions. | <ul style="list-style-type: none">• Revise business tax form instructions to remind taxpayers of 1099-MISC reporting requirements for specific expense types. |

Impediments facing 1099-MISC payers**Options for increasing voluntary compliance and related pros and cons**

Some payers find 1099-MISC submission burdensome/inconvenient.

- | | |
|--|--|
| <p>1. Some payers misreport or neglect to report payee taxpayer identification numbers (TINs) and could be subject to penalty and required to do backup withholding on 1099-MISC payments to payees with bad TINs.</p> <p>Some payers misreport 1099-MISCs using the payee's partnership's name and TIN rather than the individual payee's Social Security Number (SSN).</p> | <ul style="list-style-type: none">• Provide education and outreach activities to<ul style="list-style-type: none">• Remind payers to secure TINs from payees for 1099-MISC reporting to avoid backup withholding for missing or incorrect TINs.⁹• Remind payers of IRS's voluntary TIN Matching program that allows authorized payers the opportunity to match payee TIN and name with IRS records free of charge before submitting the 1099-MISC.^h• Increase awareness of IRS policy on waiving incorrect or missing TIN information penalties and how a payer can establish reasonable cause.• Require payers to validate payee TINs (IRS, 2007).ⁱ<ul style="list-style-type: none">• Increase reporting burden for payers.• Decrease number of 1099-MISCs unmatchable to payees for IRS's automated enforcement programs. |
| <p>2. Payers submitting paper 1099-MISCs are required to use forms printed with special red ink scannable by IRS. IRS does not offer a fillable form for downloading on its Web site, and forms computer generated from accounting or tax software are not acceptable formats. Some payers submit black and white 1099-MISCs anyway.</p> | <ul style="list-style-type: none">• Provide an online portal for electronic submission similar to the Social Security Administration's portal for W-2s (ETAAC, 2007, 2008).^j<ul style="list-style-type: none">• Potentially affects a majority of payers as 90 percent of payers used paper forms and 64 percent of all payers submitted one to four forms in 2006.• Facilitate more accurate 1099-MISC entry and processing for IRS.• Implementation has costs, and IRS currently has no plans for a 1099-MISC portal.• Allow payers to submit computer generated black and white 1099-MISCs (IRSAC, 2005).<ul style="list-style-type: none">• IRS currently has no plans to upgrade its scanning technology to eliminate the special red ink requirement and process computer-generated black and white 1099-MISCs.• IRS submission processing officials said some black and white computer-generated forms are currently scanned but require additional work to ensure information was correctly scanned. These officials predicted that relaxing the red ink requirement would overwhelm the current scanning operation. IRS has not conducted any research to determine the extent to which computer-generated black and white forms slows 1099-MISC processing.<ul style="list-style-type: none">• Lowering the 250 threshold for electronic submission would reduce the total number of paper submissions and might ameliorate such slowdown (ETAAC, 2007). Lowering the threshold would require legislative action.• Promote awareness of any offers for free electronic 1099-MISC submission services available through IRS's authorized e-file partners. (IRS)<ul style="list-style-type: none">• A few vendors in the past offered free online preparation and submission for small numbers of 1099-MISCs for businesses.^k |
| <p>3. Payers using IRS's Filing Information Returns System (FIRE) must register and buy software to format 1099-MISC data transmission, or pay a vendor to submit their forms electronically.</p> | <p>Provide an online portal (discussed above)</p> <p>Online portal likely to require registration with IRS and may be convenient for payers submitting a few forms, but not likely convenient for payers submitting 250 or more forms.</p> |

Source: GAO analysis.

^aIRSAC, *Internal Revenue Service Advisory Council Public Meeting, November 17, 2005* (Washington, D.C.: Nov. 17, 2005) and IRS, *IRS Oversight Board, Annual Report 2007*, (Washington, D.C.: March 2008).

^bFor example, the Form 1040 tax return instructions to help individuals determine whether they are required to file an income return. Also, the Schedule SE highlights who must file the schedule for self-employment tax and includes a chart to help individuals determine whether to file the short or long Schedule SE.

^cGAO/GGD-91-118. In 1992, we recommended federal agencies issue information returns on payments to corporations (GAO/GGD-92-130). In 2004, we reported that revenues from extending reporting requirements to corporate payments could increase by billions of dollars (GAO-04-649). See GAO, *Tax Administration: Costs and Uses of Third Party Information Returns*, GAO-08-266 (Washington, D.C.: Nov. 20, 2007) for a list of how the additional costs payers would incur could be mitigated.

^dDepartment of the Treasury, *General Explanations of the Administration's Fiscal Year 2009 Revenue Proposals* (February 2008).

^eTo minimize burden on small businesses, the National Taxpayer Advocate recommended expanding 1099-MISC reporting to include corporations only if IRS's National Research Program (NRP) found significant levels of noncompliance among small corporations. *National Taxpayer Advocate, 2007 Annual Report to Congress Vol. 1 Section Two- Key Legislative Recommendations*, (Washington, D.C.: Jan. 9, 2008). This phase-in approach does not simplify the need to track the payee's status.

^fIn 2005 testimony, the National Taxpayer Advocate recommended reducing or eliminating the \$600 threshold. In 2006, IRPAC recommended increasing the medical payment threshold to \$5,000 to reduce payer reporting burden.

^gIRS Form W-9 can be used to obtain and certify the payee's tax identification number(TIN). IRS uses the combination of the payee name and TIN to match the information reported on a 1099-MISC with information reported by the payee on income tax returns.

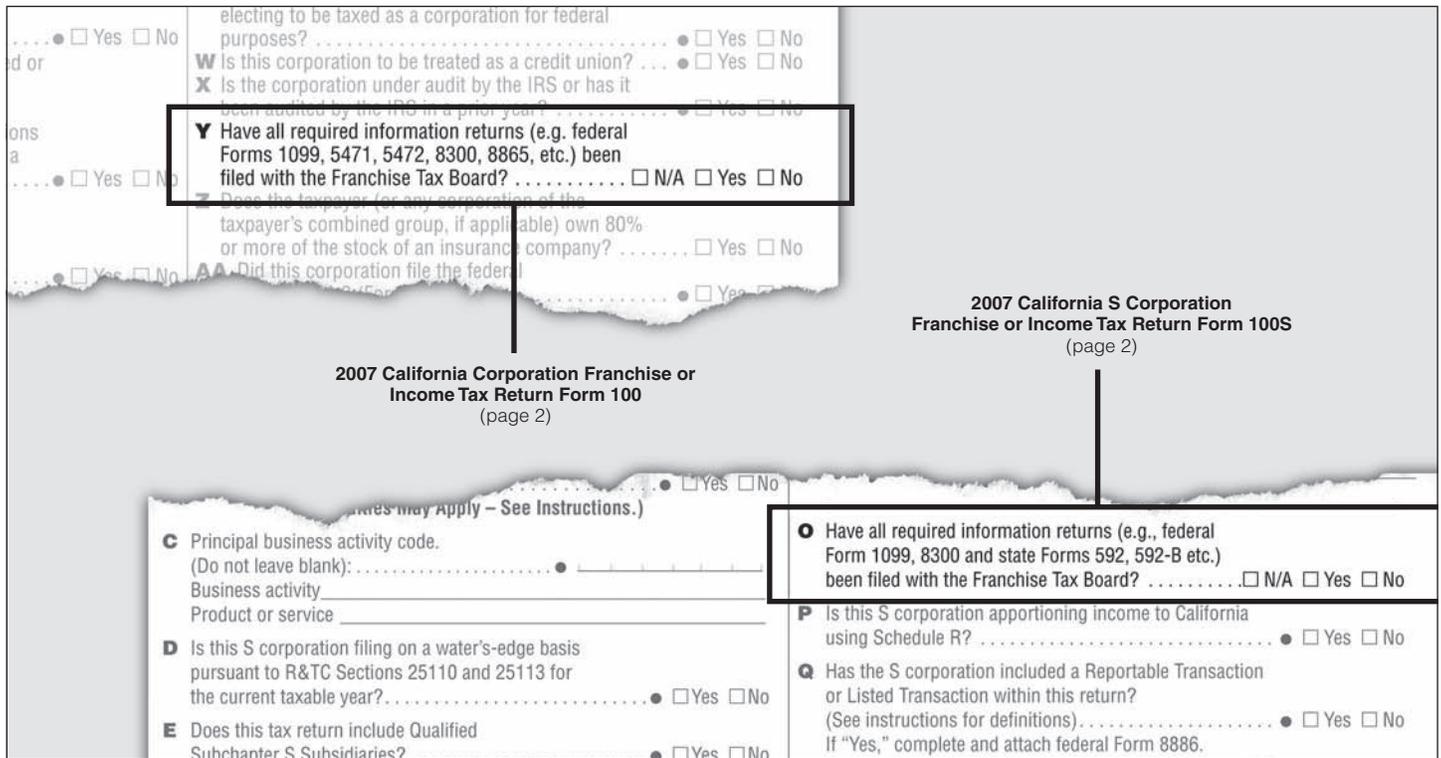
^hCurrently, TIN matching is only available to authorized payers that filed information returns with IRS in at least one of the two past tax years.

ⁱInternal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, (Washington, D.C.: Aug. 2, 2007).

^jThe Social Security Administration offers free online submission of W-2s for payers submitting 20 or fewer forms.

^kIn 2007, we reported that ,according to vendors we interviewed, prices for preparing and submitting 1099-MISCs were relatively low, ranging from about \$10 per form for 5 forms to about \$2 per form for 100 forms, with one of them charging about \$.80 per form for 100,000 forms. See GAO, *Tax Administration: Costs and Uses of Third-Party Information Returns*, GAO-08-266 (Washington, D.C.: Nov. 20, 2007).

Figure 6: California State Tax Forms for Corporations and S Corporations, Tax Year 2007



Source: State of California.

According to our interviewees, multiple approaches could help IRS to increase payer compliance with 1099-MISC reporting requirements. For some options, such as eliminating the exemption on reporting corporate payments, the evidence shows that the benefits outweigh the costs. For other options, it is not clear whether the benefits outweigh the associated costs. In those cases, additional research by IRS could help to evaluate the feasibility of more costly options, such as allowing black and white paper 1099-MISCs. Action to move forward on options to target outreach to specific payer groups or clarify guidance to reduce common reporting mistakes would hinge on IRS first conducting research to understand the magnitude of and reasons for payer noncompliance.

IRS Aims to Improve AUR Efficiency but Lacks a Systematic Process for Learning about the Causes of Mismatches

Adopting strategies, discussed above, to promote voluntary compliance with 1099-MISC reporting requirements and to better monitor payer noncompliance would likely increase the number of 1099-MISCs IRS receives from payers. This in turn would increase the number of automated mismatches identifying potential underreporting by payees. However, the AUR program does not pursue all the mismatches from the 1099-MISCs currently received. Given limited resources for the AUR program, it is important for IRS to find ways to more efficiently expand AUR coverage and select the best 1099-MISC related cases to work.

While 1099-MISCs constituted 5 percent of all information returns AUR used to detect underreporting, a significant portion of the AUR cases and assessments were based on 1099-MISC information, as shown in table 2.⁴¹ For tax year 2004 (the last full year available), 19 percent of 1099-MISC related cases were selected for review, yielding 21 percent of the additional tax dollars assessed by the AUR program. From the 1.9 million 1099-MISC related cases with identified income discrepancies, AUR selected a larger proportion (47 percent) for review than from the AUR inventory as a whole (31 percent). Over three-quarters of all 1099-MISC related cases selected involved nonemployee compensation.⁴² The remaining 1099-MISC related cases involve other types of 1099-MISC payments, such as those for rent and medical services. For tax year 2004, 1099-MISC related cases in total yielded \$972 million additional assessments, accounting for 21 percent of AUR assessments.⁴³

⁴¹The 1099-MISC related cases include eight of over 60 AUR categories: (1) nonemployee compensation of 50 percent or more of the taxpayer's income (2) nonemployee compensation with fishing income where the tax change was 80 percent or greater than the original tax reported, (3) fishing income, (4) rents and royalties, (5) medical payments, (6) other income, (7) payments in lieu of dividends, and (8) crop insurance.

⁴²Nonemployee compensation cases include those where 50 percent or more of the taxpayer's income was nonemployee compensation or where the tax change was 80 percent greater than the original tax reported. Nonemployee compensation cases can yield both income and self-employment tax assessments and accounted for 91 percent of additional assessments from 1099-MISC related cases for tax year 2004.

⁴³Additional AUR assessments include total assessments recommended for taxes and associated penalties net of any refunds. Amounts of recommended assessments could be abated in appeals or may not be collected, and thus should not be construed as amounts ultimately collected.

Table 2: 1099-MISC-Related Cases Represent a Significant Share of the Cases Selected for AUR Review and Taxes Assessed, Tax Year 2004

	All Information Returns Submitted (thousands)	AUR Case Inventory (thousands)	Cases Selected for AUR review (thousands)	Percent of AUR Inventory Selected	Additional Tax Dollars Assessed (millions)
All AUR cases ^a	1,487,000 ^b	14,993	4,645	31.0%	\$4,673
1099-MISC related cases ^c	79,738	1,868	873	46.7%	\$972
1099-MISC Share of all AUR Cases	5%	13%	19%		21%

Source: GAO analysis based on IRS data.

^aTotal information returns used in IRS's computer matching to identify the AUR program's inventory of potential mismatches included more than 231 million W-2s for employee wages.

^bThe total number of information returns submitted is only significant to the millions.

^cThe 1099-MISC related cases include nonemployee compensation as well as other miscellaneous payments such as for fishing, medical services, and crop insurance.

IRS's New Soft Notice Initiative Could Increase AUR Program Efficiency

AUR currently has a limited reach, pursuing less than half of 1099-MISC related cases in its inventory and less than a third of the overall inventory for tax year 2004. Attempting to increase AUR program efficiency, IRS has pilot tested an automated "soft notice" program since 2005. The goal of this program pilot is to increase accurate reporting compliance with minimal additional expenditures for IRS. For this program pilot, AUR first selected cases from the inventory that involved relatively small amounts of money and thus would not have been selected for review, and then expanded the pilot to include cases with higher-dollar potential tax assessments. The 2,505 cases in the pilot test during fiscal years 2005 and 2006 included 550 nonemployee compensation cases based on 1099-MISC information. AUR sent letters to these taxpayers asking them to either fix the identified discrepancy by filing an amended return. However, if the taxpayer's reported income is correct, IRS encouraged the taxpayer to contact the third party providing the information to IRS. The soft notice is intended to educate and promote future compliance, requiring minimal response to the notice from taxpayers.

Based on the pilot, IRS concluded that the soft notice approach increased taxpayer compliance, without placing a heavier burden on AUR resources to respond to taxpayers' queries. In total for the 2 pilot years, 25 percent of taxpayers receiving AUR soft notices filed amended tax returns, and 78 percent corrected their reporting behavior in the next year's AUR inventory. Less than 13 percent called IRS to inquire about the soft notices. With phased rollout slated to begin in fiscal year 2009, AUR would

be able to achieve a greater coverage over the balance of cases in the inventory beyond those selected for AUR review. Accordingly, the soft notice approach may be an innovative, cost-effective way for IRS to have a greater enforcement presence using 1099-MISC information. However, it is too early to assess whether the effectiveness of the soft notice pilot can be generalized to the AUR program overall. For tax year 2007, IRS plans to send about 30,000 AUR soft notices across the range of AUR income categories—including about 4,400 1099-MISC related cases. As of October 2008, IRS plans to collect data on taxpayer responses and develop an analysis plan to determine which AUR case types are suited for future soft notices.

IRS Could Use Data on Unproductive 1099-MISC Cases to Better Target Case Selection and Provide Service to Reduce Misreporting

Some cases AUR selected from its inventory are not productive; that is, some cases do not yield any additional tax revenue. About 36 percent of the 1099-MISC related cases selected for tax year 2004 were manually screened out by AUR reviewers without taxpayer contact. Such cases may be screened out because the payee erroneously reports a 1099-MISC payment on the wrong tax return line but paid the correct taxes or because the discrepancy was because of an IRS error in transcribing a paper 1099-MISC. Of the 64 percent of the tax year 2004 1099-MISC cases selected that involve taxpayer contact, about 22 percent yielded no change in tax assessments. These unproductive cases cost IRS time and money that could be spent pursuing other taxpayers who owe additional taxes and burden honest taxpayers who must respond to IRS inquiries. A case may result in no tax change if a taxpayer responds to the AUR notice with information explaining the discrepancy. For example, an unproductive 1099-MISC discrepancy may be because the payer reported payments made to a partnership under an individual partner's SSN rather than under the partnership TIN.⁴⁴

The screen-out process and handling taxpayer contacts are labor-intensive for AUR compared with computer processing, so reducing the number of unproductive cases would free up resources to work more productive cases. IRS officials told us that in fiscal year 2007, IRS implemented a new case selection tool using historical data to target cases with high assessment potential and that this new methodology has yielded progress in terms of increased AUR assessments during fiscal year 2008. An

⁴⁴A case also may result in no tax change if, for example, the payee incorrectly reported net income instead of reporting the full 1099-MISC payment and associated expenses.

additional approach would be to gain insight into the source of discrepancies between information reported by payers submitting 1099-MISCs and by payees filing tax returns. An understanding of the specific causes could help IRS in evaluating its matching operations and refining the AUR case selection tool for 1099-MISC related cases. Additionally, the information would be useful to help IRS target activities to clarify guidance or target outreach to educate payers or payees to avoid common reporting errors.

Currently, IRS does not systematically collect and analyze information on the causes of unproductive mismatches that would allow it to determine how best to reduce or eliminate such mismatches. The AUR management information system has codes showing whether the case was closed with or without a tax change, but does not specify how AUR accounted for the discrepancy. For example, no change closing codes do not specify whether the discrepancy was because of payer misreporting, payee misreporting, or IRS error in transcribing paper 1099-MISCs. Additionally, IRS does not routinely collect data on the screen-out process, so IRS does not have information on the nature and cause of recurring 1099-MISC discrepancies. According to AUR officials, the AUR program periodically does special analyses to identify how to reduce screen-out rates but has not specifically studied 1099-MISC related cases. Capturing information on specific reasons why cases were unproductive is one approach to improve AUR's efficiency. The information would be useful to the AUR program in making informed decisions on how to improve the match process and refine its case selection methodology for 1099-MISC related cases.

Moreover, IRS could draw on AUR data to identify common 1099-MISC reporting errors and determine how to target service activities to improve payer and payee reporting. For example, IRS could avoid some unproductive AUR cases by reminding taxpayers doing business as a corporation or partnership to provide their business TIN rather than their SSNs to payers. Insight about productive AUR cases also could help IRS identify opportunities to educate taxpayers on how to avoid common mistakes and correctly report 1099-MISC payments.

Conclusions

The 1099-MISCs are a powerful tool through which IRS can encourage voluntary compliance by payees and detect underreported income of payees that do not voluntarily comply. However, IRS has limited knowledge about the extent of payer noncompliance with 1099-MISC reporting requirements. If 1099-MISC reporting compliance increased by even one percent, it could result in an additional \$60 billion of payments

reported. Without better information about the extent and causes of payer noncompliance, IRS has no way of determining if placing a heavier emphasis or shifting more resources toward addressing 1099-MISC payer noncompliance could lead to an increase in payee voluntary compliance and ultimately help reduce the tax gap.

IRS could make better use of existing data to detect some kinds of payer noncompliance. Extending the stop filer notice program used for federal payers may be one tool for IRS to reach out to other government and business payers that drop off the radar. Developing an estimate of payer noncompliance and the characteristics of those payers would be key for IRS in developing a cost-effective strategy to identify payers that never submit 1099-MISCs.

Another approach for increasing 1099-MISC reporting compliance is for IRS to address the variety of impediments facing payers preparing and submitting 1099-MISCs. Eliminating the reporting exemption for payments to corporations would ease payer burden associated with first determining the status of their payees to identify whether payments are reportable. As early as 1991, we determined that the benefits in terms of increased tax revenue and voluntary taxpayer compliance would exceed the costs of extending 1099-MISC reporting, although we did not formally recommend the matter for congressional consideration at that time. IRS agrees that the benefits of eliminating the corporate exemption outweigh the costs, and the Bush Administration has proposed legislative action in its last two budgets. Although it is unclear the extent to which taxpayers read guidance on reporting requirements, especially taxpayers who use paid preparers, options for additional guidance and general reminders are a low cost way to help payers understand whether they have a 1099-MISC reporting requirement. For other options where it is unclear whether the benefits outweigh the associated costs, additional research by IRS could help to evaluate whether specific options would be feasible or effective in increasing payer compliance.

In turn, IRS research and other activities aimed at increasing payer reporting compliance would likely increase the number of 1099-MISC related AUR cases. Reducing the number of unproductive cases would free up resources for IRS to handle this increased workload and make better use of the 1099-MISC information it receives.

Matter for Congressional Consideration

To simplify the burden that the corporate exemption places on payers to distinguish payees' business status and also provide greater information reporting, Congress should consider requiring payers to report payments to corporations on the form 1099-MISC, as we previously suggested and as proposed in the Bush Administration's budget.

Recommendations for Executive Action

We are making eight recommendations to the Commissioner of Internal Revenue.

To gauge the extent of 1099-MISC payer noncompliance and its contribution to the tax gap, we recommend that the Commissioner of Internal Revenue as part of future research studies

- develop an estimate of 1099-MISC payer noncompliance and
- determine the nature and characteristics of those payers that do not comply with 1099-MISC reporting requirements so that this information can be factored into an IRS-wide strategy for increasing 1099-MISC payer compliance.

To increase IRS's ability to detect 1099-MISC payer noncompliance, we recommend that the Commissioner of Internal Revenue

- test the option of developing a stop filer notice program to target business, state, and local entities that submitted 1099-MISC one year but did not do so the next.

To help payers better understand their 1099-MISC reporting responsibilities, we recommend that the Commissioner of Internal Revenue

- add a general reminder to Publication 535 Business Expenses to highlight 1099-MISC reporting responsibilities;
- assess whether adding a checkbox to business tax returns, inquiring whether all 1099-MISCs have been submitted, to serve as a reminder to payers would help increase 1099-MISC payer compliance; and
- include a chart on the Form 1099-MISC as well as business income tax instructions for distinguishing reportable from non-reportable payments and for calculating whether reportable payments reached the 1099-MISC reporting threshold.

To reduce the submission burden facing many payers each submitting small numbers of 1099-MISCs, we recommend that the Commissioner

-
- collect data on the numbers of computer-generated black and white 1099-MISCs submitted by payers and the labor spent reentering forms that cannot be scanned, and evaluate the cost-effectiveness of eliminating or relaxing the red ink requirement.

To help IRS improve its use of 1099-MISC information, we recommend that the Commissioner

- collect and analyze data on the types of unproductive AUR cases to help identify reoccurring errors for use in the AUR case selection process and for identifying ways to improve guidance and outreach to help payers and payees more accurately report 1099-MISC payments.

Agency Comments and Our Evaluation

In written comments on a draft of this report (which are reprinted in appendix II), IRS's Deputy Commissioner for Services and Enforcement acknowledged that the evidence in our report indicates that the number of 1099-MISCs that payers are required to submit could be much higher than what IRS currently receives. IRS agreed with six of our eight recommendations. IRS staff provided technical comments that we incorporated as appropriate.

IRS agreed to gather additional data from its ongoing and planned NRP studies to determine the extent of 1099-MISC noncompliance. IRS also agreed to determine the nature and characteristics of noncompliant 1099-MISC payers once several years of reporting compliance data are available. In addition, IRS agreed to (1) analyze PMF data and develop a 1099-MISC stop filer notice test; (2) evaluate the cost effectiveness of eliminating or relaxing the red ink requirement; and (3) analyze data for a sample of AUR cases to identify opportunities to improve case selection and outreach and education for payers and payees.

IRS disagreed with our recommendation to assess whether adding a checkbox to business tax returns would increase 1099-MISC reporting compliance. IRS agreed to enhance instructions about 1099-MISC reporting requirements to improve voluntary compliance by payers. We do not believe this is fully responsive to our recommendation. IRS stated that a similar question was removed from the corporate tax return after the Paperwork Reduction Act of 1980 was enacted. IRS said that the act requires reducing unnecessary burden on taxpayers and prohibits collecting information already available. We recognize that the Paperwork Reduction Act requires agencies to certify that any collection of information avoids unnecessary duplication and is necessary for the proper performance of the functions of the agency, including whether the

information has practical utility. In recommending that IRS explore the potential for this option to increase 1099-MISC reporting, we believe information about the experience of California and other states using a similar checkbox query could yield insight on how this option could improve payers' reporting compliance by reminding payers of their reporting obligations. As discussed in this report, many taxpayers rely on tax preparers and tax software and may not look at IRS guidance. For this reason, the checkbox option—which we clarified would require taxpayers to respond under penalty of perjury—might be more effective because it would force tax preparers and software to query taxpayers about their expenses. Further, results from the evaluation we recommend could be useful to IRS in revisiting its 1981 assessment and weighing the benefits and burdens associated with the checkbox option. We clarified in the report that the National Taxpayer Advocate has reported that the taxpayer burden associated with the checkbox option would be small.

IRS also disagreed with our recommendation to include a chart in the 1099-MISC instructions and business income tax instructions. IRS stated that the Form 1099-MISC instructions already contain two bulleted lists describing which payments are reportable as well as explanations of the rules for specific payment types. However, these two lists as well as a third bulleted list describing reportable payments to corporations include 19 bullet points spanning two pages of the eight pages of single-spaced 1099-MISC instructions. We added an example to the report citing a chart in IRS's 19-page general instructions that highlights what payments and amounts to report on the Form 1099-MISC. We believe that the chart approach is an effective way to provide taxpayers with a quick guide for navigating the detailed instructions for the Form 1099-MISC. For this reason, we continue to recommend adding a chart to the 1099-MISC instructions and business tax instructions.

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

If you or your staff have any questions, please contact me on (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, prominent initial "J".

James R. White
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

The objectives of this report were to determine: (1) what IRS knows about 1099-MISC reporting noncompliance by payers; (2) how IRS detects and pursues 1099-MISC reporting noncompliance by payers; (3) what impediments payers encounter in preparing and submitting accurate 1099-MISC forms and what options could help IRS address these impediments; and (4) what opportunities exist to enhance IRS's use of 1099-MISC information to both detect payee noncompliance and promote voluntary compliance.

For background about 1099-MISC reporting requirements, we reviewed laws and regulations as well as IRS guidance related to the Form 1099-MISC and also spoke with IRS officials. For background about the numbers and amounts of payments reported on the 1099-MISC, we obtained information reporting program data from Martinsburg Computing Center for tax year 2006. We also obtained data from IRS's Payer Master File (PMF) on the aggregate numbers of payers submitting 1099-MISCs on paper and electronically for tax year 2006. We determined that these data were sufficiently reliable for our descriptive purposes.

To determine what IRS knows about the extent of 1099-MISC payer noncompliance, we reviewed IRS documents including plans for reducing the federal tax gap and National Research Program (NRP) as well as budget proposals to expand 1099-MISC reporting.¹ Other reports we reviewed include past GAO and Treasury Inspector General for Tax Administration (TIGTA) reports on 1099-MISC reporting compliance by federal, state and local government entities.² We also interviewed NRP officials and staff about research on 1099-MISC reporting compliance.

To obtain perspective on the potential magnitude of payer noncompliance, we compared the number of small businesses filing tax returns with number of small businesses submitting 1099-MISCs for tax years 2002 to 2005. We used IRS's definition of small businesses—businesses entities including sole proprietorships, S-corporations, and partnerships with assets under \$10 million—under supervision of IRS's Small Business and

¹Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, (Washington, D.C.: Aug. 2, 2007).

²See GAO, *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns*, [GAO-04-74](#) (Washington, DC: Dec. 5, 2003) and Treasury Inspector General for Tax Administration: *More Complete and Accurate Data are Needed to Assess the Impact of Actions to Address Compliance Reporting of State and Local Government Entities* (Reference No. 2007-10-081, June 8, 2007).

Self-Employed (SB/SE) business operating division. We obtained total numbers of small business tax returns submitted in these four years from IRS's Business Master File and the Individual Master File. For these IRS databases, we relied on the work we perform during our annual audits of IRS's financial statements.³ While our financial statement audits have identified some data reliability problems associated with coding some fields in IRS's tax records, we determined that the tax form count data were sufficiently reliable to address the report's objectives. We then compared the aggregate number of payers identified as small businesses from IRS's PMF database to calculate the percentage of small business tax filers that submitted 1099-MISCs. The last complete year of payer type information available at the time of our analysis was 2005. While we could not isolate which businesses were required to submit a 1099-MISC but did not, we determined the data were sufficiently reliable to show how many small businesses submitted 1099-MISCs to IRS.

We could not produce a comparable 1099-MISC reporting percentage for large corporations and partnerships under supervision of IRS's Large and Mid-Size Business (LMSB) business operating division. Large businesses may file a consolidated corporate income tax return under the parent company's taxpayer identification number (TIN) for all its subsidiaries but submit 1099-MISCs under the individual subsidiaries' TINs.⁴

To obtain additional perspective on potential 1099-MISC payer reporting noncompliance among small businesses, we examined the 1099-MISC submission rates for a sample of small business Schedule C filers. Contract labor payments to a non-incorporated payee totaling \$600 or more are reportable on a 1099-MISC, so we used contract labor line on Schedule C as proxy for a possible 1099-MISC reporting requirement. We included all Schedule C filers that reported \$600 or more contract labor expenses from IRS's Statistics of Income (SOI) for tax year 2006 (the last year available).⁵ We identified the Schedule C filers and provided their TINs to IRS. IRS

³GAO, *Financial Audit: IRS's Fiscal Years 2008 and 2007 Financial Statements*, GAO-09-119 (Washington, D.C.: Nov. 10, 2008).

⁴For large businesses, subsidiaries with over 80 percent of its control under its parent company have the option of filing income tax under its parent company using a consolidated corporate income tax return.

⁵SOI is a widely used IRS research database. The SOI files are a stratified probability sample of unaudited income tax returns. Data analysis results using SOI are subject to imprecision owing to sampling variability.

provided data on whether these filers submitted a 1099-MISC as indicated on the IRS's Information Return Master File. This resulted in 44 percent of the SOI sample (unweighted) matching 1099-MISC forms. We then used these matches to produce generalizable estimates of Schedule C filers reporting \$600 or more in contract labor expenses. Using SOI sampling weights, we provide the margin of error based on 95 percent confidence for our SOI estimate. We determined the SOI results were reliable for estimating how many Schedule C filers who reported contract labor submitted a 1099-MISC. However, we could not discern whether those that did not submit 1099-MISCs had a filing requirement due to the exceptions for any payment under \$600 and payments to corporations.

To determine how IRS detects and pursues payer noncompliance with 1099-MISC reporting requirements, we reviewed IRS's procedures for checking compliance used by IRS's business operating divisions—Tax Exempt and Government Entities Division (TE/GE), LMSB, and SB/SE. We also interviewed IRS examination and compliance staff from each of these divisions. Within TE/GE, we spoke with IRS officials responsible for working with federal, state and local government entities as well as Indian tribal governments.⁶ We interviewed IRS officials and staff about information returns processing and related penalties. Data on IRS's small business examination coverage came from IRS's publicly available Data Book. We believe the data were sufficiently reliable for the purposes of our review.

To identify impediments that payers encounter with 1099-MISC reporting, options and challenges IRS confronts in addressing these concerns, we reviewed IRS and IRS advisory committee reports, previous GAO reports as well as those of the National Taxpayer Advocate. Further, we reviewed IRS's 1099-MISC form, instructions, and related guidance in addition to outreach material used to educate payers about 1099-MISC reporting requirements. We interviewed members of IRS advisory groups—Electronic Tax Administration Advisory Committee (ETAAC), Information Reporting Program Advisory Committee (IRPAC), and Internal Revenue

⁶We did not address 1099-MISC payer reporting compliance by tax-exempt organizations, such as charitable organizations and foundations, or employee retirement plans.

Service Advisory Council (IRSAC).⁷ To obtain perspectives from tax preparers and others professionals knowledgeable about 1099-MISC payers, we interviewed attendees at IRS's fall 2007 National Public Liaison meeting that included members of national stakeholder organizations, business and professional associations, tax professionals who prepare and submit forms to the IRS, and tax software vendors. We also observed IRS's November 2007 National Phone Forum on Form 1099-Information Reporting and reviewed IRS's question and answer summary provided to participants.⁸ We also reviewed California Franchise Tax Board's corporation and S corporation tax return forms and interviewed the California officials about their experience with the check-the-box question on the California business returns.

To determine IRS's use of 1099-MISC information, we reviewed IRS guidance for 1099-MISC submission processing and the Automated Underreporter (AUR) program. We also interviewed IRS's Martinsburg Enterprise Computing Center, AUR, and nonfiler program officials and staff. We obtained program data on the AUR inventory, case selection, and additional dollars assessed for tax year 2004, the last full year available in time for this report. The number of information returns submitted to IRS came from SOI's Data Book. We determined that the data we used were sufficiently reliable for the purpose of our review.

IRS nonfiler officials stated they are not able to distinguish nonfiler income tax return cases that were identified through 1099-MISC information from those identified through its stop filer program that identifies a gap in a taxpayer's filing of tax returns. Consequently we were unable to quantify the extent to which 1099-MISC information is used to detect payee nonfiling in the program.

We conducted this performance audit from June 2007 through January 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to

⁷All three IRS advisory groups provide a public forum for discussions between IRS officials and representatives of the public. ETAAC advises on IRS's electronic tax administration activities. IRPAC advises on improving information reporting, while IRSAC advises on emerging tax administration challenges and the perspectives of specific tax payer segments.

⁸IRS offered three sessions of its free 1099-MISC phone training for tax practitioners, businesses, government agencies, and other interested parties. Participants could ask questions during the sessions or submit their questions by email for IRS to answer.

obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

January 13, 2009

Mr. James R. White
Director, Tax Issues
United States General Accounting Office
Washington, DC 20548

Dear Mr. White:

Thank you for the opportunity to review your draft report entitled "Tax Gap – IRS Could Do More to Promote Compliance by Third Parties With Miscellaneous Income Reporting Requirements (GAO-09-238)."

We recognize information reporting by third parties is an important tool in addressing the tax gap and agree many of your suggestions will assist in promoting voluntary compliance with the miscellaneous income (Form 1099-MISC) information reporting requirements.

For tax year 2006, IRS received over 82 million Forms 1099-MISC from third parties, reporting over \$6 trillion in payments. However, as your report indicates, there is evidence the number required to be filed could be much higher. IRS will gather additional data during the on-going National Research Program (NRP) individual income tax reporting compliance studies to stratify the extent of payer noncompliance with filing information returns. In our recently completed individual NRP, we included several questions related to the filing of information returns and imposition of failure to file penalties. Plans are also underway for an Employment Tax NRP study. The combined information from these NRP studies will provide specific information related to payer noncompliance that will be used to refine our efforts to address reporting compliance.

Your report also considered numerous factors influencing the filing of Form 1099-MISC. To improve reporting compliance we will 1) enhance our instructions to taxpayers regarding appropriate filing of information returns, 2) review the requirement to submit information returns using specialized red ink, 3) analyze data from the Payor Master File (PMF) and, if indicated, implement a test of a Form 1099-MISC Stop Filer Program and 4) analyze data from AUR cases to identify opportunities to improve selection criteria as well as outreach and education for payers and payees.

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The enclosed response addresses each of your recommendations in more detail. If you have any questions, please contact Christopher Wagner, Commissioner, Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,



Linda E. Stiff

Enclosure

Enclosure

RECOMMENDATION 1

Develop an estimate of 1099-MISC payer noncompliance.

COMMENT

IRS will gather additional data during the on-going individual income tax reporting compliance studies. Additional data will be generated by an NRP reporting compliance study for employment tax, which is now in the planning stages. Data collected from these studies should provide valuable information regarding whether service recipients are appropriately reporting required payments on Form 1099-MISC.

IRS researchers will use all of these sources of data to examine the extent of Form 1099-MISC payer noncompliance. The individual income tax reporting compliance studies are underway for tax year 2006 and 2007. Examinations for the employment tax reporting compliance study should begin in 2010. The data from employment tax study are expected to become available in January 2012. In order to draw reliable conclusions, we plan to combine the results from several years of these studies

RECOMMENDATION 2

Determine the nature and characteristics of those payers who do not comply with 1099-MISC reporting requirements so that this information can be factored into an IRS-wide strategy for increasing 1099-MISC compliance.

COMMENT

IRS researchers will examine data to determine the nature and characteristics of noncompliance among 1099-MISC payers once the results from several years of the reporting compliance studies become available.

RECOMMENDATION 3

Test the option of developing a stop filer notice program to target business, state, and local entities that submitted 1099-MISC one year but did not do so the next.

COMMENT

We will analyze data from the Payor Master File (PMF) to determine an estimate of the number of filers who filed Form 1099-MISC in tax year 2005 versus tax year 2006. A team will be formed to develop a stop-filer test based upon the results of the analysis. The team will consist of the various Business Operating Divisions (BODs) where significant scope and risk have been determined.

RECOMMENDATION 4

Add a general reminder to Publication 535 *Business Expenses* to highlight 1099-MISC reporting responsibilities.

COMMENT

We agree to adopt this recommendation.

RECOMMENDATION 5

Assess whether adding a checkbox to business tax returns, inquiring whether all 1099-MISCs have been submitted, to serve as a reminder to payers would help increase 1099-MISC payer compliance.

COMMENT

The question suggested in your report was previously on Form 1120 until 1980 when it was removed in 1981 due to the enactment of the Paperwork Reduction Act (PRA) of 1980. The PRA requires us to reduce unnecessary burden on taxpayers and prohibits us from collecting information already available from other government sources. However, we agree to revise the instructions, where appropriate, to remind taxpayers of their reporting obligations.

RECOMMENDATION 6

Include a chart on the Form 1099-MISC as well as business income tax instructions for distinguishing reportable from non-reportable payments and for calculating whether reportable payments reached the 1099-MISC reporting threshold.

COMMENT

The Instructions for Form 1099-MISC contain a bulleted list that describes the reportable payments and minimum dollar amount required for each payment. The instructions also contain a bulleted list of payments not required to be reported and provide explanations of the reporting rules for certain types of payments.

RECOMMENDATION 7

Collect data on the numbers of computer-generated black and white 1099-MISCs submitted by payers and the labor spent reentering forms that cannot be scanned; and evaluate the cost-effectiveness of eliminating or relaxing the magnetic red ink requirement.

3

COMMENT

We are unable to collect data on the numbers of computer-generated black and white Forms 1099, MISC as we cannot determine which black and white forms are computer-generated. Additionally, Forms 1099 are not processed by specific type, but are worked as Information Return Processing (IRP) documents.

We will conduct control tests to determine the cost of processing black and white versus "red drop-out ink" IRP documents. Testing will begin in May 2009 and run through June 2009. By October 15, 2009, we will evaluate the cost effectiveness of eliminating or relaxing the "red drop-out ink" requirement.

RECOMMENDATION 8

Collect and analyze data on types of unproductive Automated Underreporter Program (AUR) cases to help identify recurring errors for use in identifying ways to improve guidance and outreach to help payers and payees more accurately report 1099-MISC payments.

COMMENT

We will review a sampling of Form 1099-MISC discrepancy cases during our AUR annual site visitations and, based on our findings, implement needed changes to improve inventory selection and outreach and education.

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

James R. White, (202) 512-9110 or whitej@gao.gov

Acknowledgments

In addition to the contact named above, MaryLynn Sergent, Assistant Director; Jeff Arkin; Bertha Dong; Ellen Grady; Leon Green; Shirley Jones; Donna Miller; Karen O'Connor; Jessica Thomsen; Cheri Truett; James Ungvarsky; Shana Wallace; and John Zombro made key contributions to this report.

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