The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedules K-1

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

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MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

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FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedules K-1 (Audit # 200230033)

This report presents the results of our review of the Underreporter program notices related to income from Schedules K-1.[1] The overall objective of this review was to determine whether Internal Revenue Service (IRS) controls were effective in ensuring the accuracy of notices issued to taxpayers who may have underreported income from Schedules K-1 on their individual income tax returns.

In a previous report,[2] we discussed how the limitations on Supplemental Income and Loss (Form 1040,[3] Schedule E) would result in unnecessary notices to taxpayers. In this report, we provide further information regarding the Schedule E limitations, discuss other causes of unnecessary notices, and discuss efforts the IRS has taken to limit these unnecessary notices.

In an effort to increase tax reporting compliance and because of a mandate from the Senate Committee on Finance, the IRS began matching information reported to

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[1] *Beneficiary's Share of Income, Deductions, Credits, etc.* (Form 1041, Schedule K-1); *Partner's Share of Income, Credits, Deductions, etc.* (Form 1065, Schedule K-1); and *Shareholder's Share of Income, Credits, Deductions, etc.* (Form 1120S, Schedule K-1).
[2] *The Internal Revenue Service Successfully Processed Schedules K-1 for Its Matching Program, However, Tax Form Changes Would Reduce Unnecessary Notices to Taxpayers* (Reference Number 2002-30-141, dated July 2002).
[3] U.S. Individual Income Tax Return.

taxpayers on Schedules K-1 to the taxpayers' individual income tax returns.[4] The IRS estimated that in Tax Year (TY) 2001, approximately $850 billion was reported to taxpayers on Schedules K-1. The IRS further estimated that between 6 and 15 percent of these taxpayers omit this type of income from their individual tax returns.

Tax professionals and others expressed concerns about the difficulty in matching information from Schedules K-1 to individual income tax returns. The IRS must ensure notices issued to taxpayers as a result of this matching are appropriate; otherwise, the IRS' compliance efforts will be compromised. Soon after this audit was initiated, the IRS suspended issuing notices resulting from underreported Schedule K-1 income and committed to evaluate the program to make enhancements. As a result, we limited our audit and are reporting on those areas where we had already started audit testing.

The IRS implemented several procedures to try and ensure notices were not issued to taxpayers unnecessarily. IRS employees made allowances for typical income offsets and identified amended Schedules K-1 or Schedules K-1 that were part of Individual Retirement Accounts and not currently taxable. The IRS also issued an E-mail tax alert and posted information on the Internet to help preparers avoid these notices. Despite these steps, the rate of assessments made on Underreporter Program cases related to Schedule K-1 income is significantly lower than the rate of assessments made for other Underreporter Program case income types. The most common reason for non-assessed Schedule K-1 cases is offsets taken by taxpayers. These offsets can be the result of taking losses not previously allowed, due to basis or at risk limitations, or the result of other expenses taken by individual partners, shareholders, or beneficiaries. In a sample of 100 notices that were screened out by IRS employees or issued to taxpayers but resulted in no change to tax, 58 percent were due to these types of offsets.

Some of the non-assessed cases resulted from IRS errors when processing paper Schedules K-1 to the IRS' Information Returns database. Even though the IRS' input error rates were very low (2.5 to 3.75 percent), these error rates, when applied to 14 million Schedules K-1, could mean between 350,000 and 525,000 inaccurate documents in the IRS' database. In a sample of 50 cases that had notices issued to taxpayers but resulted in no change to tax, 22 percent of the notices were the result of IRS errors made when entering data from paper Schedules K-1 to IRS computers. Because paper Schedules K-1 must be entered manually into the IRS' database, the data is subject to human error. If the IRS took steps to receive more Schedules K-1 electronically or in scannable format, it could bypass the need for manual processing of most of these schedules.

We recommended that the IRS make changes to the Form 1040 Schedule E to account for the original amount of Schedule K-1 income and to show offsets to this income. This would facilitate easier comparisons to Schedules K-1 and make the matching program more effective and less subject to extensive manual screening. We further

[4] The IRS' Underreporter Program compares the IRS' database of information returns filed by employers, banks, corporations, etc., to the IRS' database of individual taxpayer returns.

recommended that the IRS re-evaluate the costs and benefits of key verifying data (entering data twice) or evaluate other ways to improve the accuracy of Schedule K-1 information in the IRS' database. The IRS should work with the Department of the Treasury to seek legislation requiring more flow-through business entities to file electronically. The resulting cost savings could be used to improve the accuracy of IRS processing of paper Schedules K-1. The IRS should also fully explore the potential of scannable Schedules K-1.

We did not have empirical data to recommend, nor did we recommend, that the IRS cancel its K-1 matching program for next year. However, a change to the Schedule E cannot be made before the TY 2002 tax forms are published, and any program in the next year will still rely heavily on data entered manually into IRS computers. Given this, we recommended that the IRS carefully consider the benefits of the program, the cost of the program to the Federal Government and to taxpayers, and the enhancements that can be made to the program in the near term as a result of its own analyses, before proceeding with a program to match all data from Schedules K-1 again in 2003.

Management's Response: The IRS agreed that changes need to be made to the Schedule K-1 matching program and is taking steps to implement our recommendations. A cross-functional task force, headed by the Office of Burden Reduction, has been formed to revise the Schedule K-1 and the Schedule E. The IRS is working with its campuses to emphasize the need to correctly enter data from Schedules K-1 into IRS computers, and continues to include Schedule K-1 processing in employee training classes. In addition, computer programming has been initiated to accept bar-coded Schedules K-1 for the purpose of data capture through scanning technology. The use of this technology will minimize inaccuracies and reduce the number of erroneously generated notices caused by input errors. The IRS also agreed to work with the Department of the Treasury to lower the current 100-partner threshold for mandatory electronic filing of partnership returns with their related Schedules K-1. Finally, the IRS conducted a review of over 3,200 cases and modified processing instructions to reduce no-change cases in the program.

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

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

Beneficiary's Share of Income, Deductions, Credits, etc. (Form 1041,[1] Schedule K-1); *Partner's Share of Income, Credits, Deductions, etc.* (Form 1065,[2] Schedule K-1); and *Shareholder's Share of Income, Credits, Deductions, etc.* (Form 1120-S,[3] Schedule K-1) are information returns filed by fiduciaries, partnerships, and S Corporations. They report the share of income, losses, deductions, and credits that flow through to each beneficiary, partner, or shareholder. The majority of Schedules K-1 received are associated with individual taxpayers, who should report the appropriate income amounts on their *U. S. Individual Income Tax Returns* (Form 1040).

Beginning with Tax Year (TY) 2000, Schedules K-1 not filed electronically were entered into Internal Revenue Service (IRS) computers for use in the IRS' Underreporter Program.[4] The IRS had not processed paper Schedules K-1 since 1995, when a small percentage of these returns were included in this program. However, the IRS received a mandate from the Senate Committee on Finance to process all Schedules K-1 for inclusion in the matching program. They stressed the risks caused by extensive use of partnerships and other flow-through entities in the area of tax schemes. But at the same time, tax professionals and oversight organizations expressed serious concerns about the difficulty in matching Schedule K-1 information with tax returns. They believed taxpayers would suffer significant burden resolving erroneous notices issued by the IRS. Accordingly, the IRS must take care to ensure Underreporter Program notices are necessary and appropriate; otherwise, IRS' compliance efforts will be compromised.

The main justification for the cost incurred to enter the data from Schedules K-1 was the compliance benefits to be achieved through the Underreporter Program, where the

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[1] U.S. Fiduciary Income Tax Return (for Estates and Trusts).
[2] U.S. Return of Partnership Income.
[3] U.S. Income Tax Return for an S Corporation.
[4] The IRS' Underreporter Program compares the IRS' database of information returns filed by employers, banks, corporations, etc., to the IRS' database of individual taxpayer returns.

Schedule K-1 information was matched against the tax returns of the individual partners, shareholders, and beneficiaries. During Fiscal Year 2002, the IRS planned to work 141,000 TY 2000 cases dealing strictly with underreported Schedule K-1 income. It also planned to include underreported Schedule K-1 income when working other types of Underreporter Program cases, such as those dealing with wages that were not reported by taxpayers.

The IRS estimated that in TY 2001, approximately 8.5 million of these flow-through returns reported $850 billion to about 19 million shareholders, beneficiaries, and partners on Schedules K-1. It also estimated that between 6 and 15 percent of the taxpayers omit their taxable flow-through income from their individual returns. In evaluating the costs and benefits of the Schedule K-1 processing and matching program, the IRS projected that a 1 percent change in the voluntary compliance level will make a difference of approximately $500 to $750 million in tax annually, which would justify the cost of the Schedule K-1 processing and matching program.

Soon after this audit was initiated, the IRS suspended issuing notices resulting from underreported Schedule K-1 income, and committed to evaluate the program to make possible enhancements. The IRS' review of the program will include analysis of over 3,000 Schedule K-1 mismatch cases. As a result of the IRS' actions, we limited the work in our audit, and are reporting on those areas where we had already begun audit testing.

This audit was conducted in accordance with *Government Auditing Standards* between June and November 2002 at the Ogden Submission Processing Center and the IRS National Headquarters. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

In a previous report,[5] we discussed how the limitations on Supplemental Income and Loss (Form 1040, Schedule E) would result in unnecessary notices to taxpayers. In this report, we provide further information regarding the Schedule E limitations, discuss other causes of unnecessary notices, and discuss efforts the IRS has taken to limit the number of unnecessary notices issued. Appendix V of this report also discusses some demographics from our samples, which are pertinent to these issues.

The Internal Revenue Service Took Some Steps to Limit Unnecessary Underreporter Program Notices Related to Income From Schedules K-1

The IRS modified procedures for screening Underreporter Program cases to reduce the number of unnecessary notices

When data captured from taxpayer records indicate taxpayers reported less income on their individual income tax returns than payers reported on the information returns, an Underreporter Program case is generated.

These cases are first screened by IRS employees, who manually review the taxpayer's individual income tax return in an attempt to account for the unreported amounts. If the amounts are located, the case is closed or "screened out," and no action is taken. If the underreported amounts are not found on a taxpayer's return during screening, the IRS sends a notice to the taxpayer regarding the underreported income amounts. Any taxpayer receiving a notice as a result of an Underreporter Program case is given an opportunity to respond to the IRS to explain how the income has been accounted for on his or her individual income tax return. If a taxpayer's response adequately accounts for the income, the case is "no changed."

Schedule K-1 income is more difficult to match than the wage, interest, dividend, pension, and other similar income types that are normally identified with the Underreporter Program. Tax law issues, such as at-risk and passive-activity limits, and offsets or business deductions taken at

[5] *The Internal Revenue Service Successfully Processed Schedules K-1 for Its Matching Program, However, Tax Form Changes Would Reduce Unnecessary Notices to Taxpayers* (Reference Number 2002-30-141, dated July 2002).

the taxpayer level make matching difficult. In addition, several types of income and deductions that are reported on the Schedules K-1 are found on many different schedules and attachments to the taxpayer's individual tax return.

Because of concerns about these difficulties in matching Schedule K-1 income, both from within the IRS and from oversight groups, the Underreporter function implemented several procedures in an attempt to ensure notices were not issued to taxpayers unnecessarily.

Employees from the Underreporter function were instructed to make special allowances for typical offset issues. They were also instructed to ensure amended Schedules K-1 were properly considered. The employees were further instructed to focus on identifying Schedules K-1 that are part of an Individual Retirement Account and not currently taxable.

The IRS provided feedback to the tax preparer community to help them avoid unnecessary Underreporter Program notices in the future

Many of the notices that were issued to taxpayers regarding underreported Schedule K-1 income could have been avoided if taxpayers (or tax preparers) had provided more detailed information that IRS employees could have relied on during the screening process. In August 2002, the IRS issued an E-mail Tax Alert and posted information on the Internet to help preparers and taxpayers avoid these notices. The information provided by the IRS included instructions to avoid netting Schedule K-1 amounts without providing detailed explanations on appropriate forms or attachments to the tax return. The IRS also instructed preparers to clearly identify amended and estimated Schedules K-1.

Forms Must Be Changed to Separately List Amounts as Originally Reported on Schedules K-1 to Improve the Matching Program's Effectiveness

The matching of income from Schedules K-1 against individual income tax returns is a difficult task. The concern expressed by oversight organizations about taxpayer burden due to unnecessary notices is valid. Historically, the number of computer generated K-1 Underreporter Program cases that are screened out initially and the number of cases that have notices issued to taxpayers that are subsequently resolved as "no change" are significantly higher than for other types of Underreporter Program cases.

In a K-1 Document Matching Project report dated July 9, 2001, the project team acknowledged the historically low rate of assessments. Figures from 1990 to 1995 showed only 11.7 percent of Schedule K-1 cases had assessments, compared to 47.4 percent for other Underreporter Program income type cases. The team believed that this was because only 20 percent of the Schedules K-1 were input to the IRS database, and that the 100 percent input would increase this assessment rate. However, as of October 28, 2002, the assessment rate for cases with underreported income from Schedules K-1 was only approximately 10 percent, even though most Schedules K-1 had been input to the Information Returns database.

The most significant cause for this low assessment rate was taxpayers making adjustments or offsets to the original Schedule K-1 amounts reported to the IRS by the parent entity. These offsets were the result of taking losses not previously allowed due to basis or at-risk limitations imposed by law, or the result of other expenses taken at the individual partner, shareholder, or beneficiary level. We reviewed a judgmental sample of 50 Underreporter Program cases that were screened out before notices were issued to taxpayers. Of these 50 cases, 28 (56 percent) were screened out as the result of these types of offsets. We also reviewed a judgmental sample of 50 notices issued to taxpayers that were eventually “no changed.” Of these 50 “no change” cases, 30 (60 percent) were the result of offsets. Overall, these offsets were the cause of 58 percent of the screened out and “no change” cases in our samples. An IRS review of 350 screened out cases at the Ogden Submission Processing Center had a similar 60 percent cause rate.

Our prior audit of the paper processing of Schedules K-1 agreed with an IRS study and recommended that the IRS change the Schedule E to account for this situation. The IRS, while agreeing to consider changes to improve the matching process, disagreed that changing the Schedule E was necessarily the best or only solution. One concern that the IRS had was the additional burden this would place on the entire population of taxpayers receiving Schedules K-1. However, we believe that taxpayers claiming additional deductions from Schedule K-1 income should show the amount of that deduction, much like they report deductions from income on many other IRS forms. Also, the vast majority of returns with Schedule K-1 related income were professionally prepared (see Appendix V), and this information would already be available to the preparer and, accordingly, would not place significant burden on this taxpayer segment. By eliminating these cases, which account for 60 percent of all generated cases, the current assessment rate of approximately 10 percent should increase to nearly 25 percent. This would result in additional revenue through more efficient use of IRS resources, and more importantly, reduce unnecessary notices to taxpayers.

Given these facts, we continue to believe that the IRS should modify the Schedule E. This should be done as soon as possible to improve the selection process and increase the efficiency of the Underreporter Program. Unless this is done, modifications to the selection process cannot be programmed into the IRS computers and the low assessment rates will continue.

Recommendation

1. The Director, Compliance, Small Business/Self-Employed (SB/SE) Division, should work with the Director, Tax Forms and Publications, Wage and Investment Division, to make changes to the Form 1040, Schedule E. Consideration should be given to classifying and reporting pass-through income to facilitate easier comparisons to Schedules K-1 and make the matching program more effective and less subject to extensive manual screening.

Management's Response: The Director, Compliance, SB/SE Division, has formed a cross-functional taskforce, headed by the Office of Burden Reduction, to revise the Schedule K-1 and Schedule E. In addition, the IRS has changed the Passive Activity Loss Limitation (Form 8582) to require taxpayers to attach the associated worksheet to their tax return.

The Internal Revenue Service Should Take Additional Steps to Ensure the Accuracy of Schedule K-1 Information in the Information Returns Database

As discussed on page 5, we reviewed 50 cases that had notices issued to taxpayers but were eventually "no changed." While the notices appeared to be understandable and written clearly, the notices were not always accurate. Eleven (22 percent) of the notices were the result of IRS errors made when processing the paper Schedules K-1 to the IRS' database. Six of these 11 cases were the result of inaccurate typing of the information, such as entering an extra number (e.g., 186,000 instead of 18,600) or entering the income as the wrong type (e.g., interest instead of ordinary business income). Five of these 11 cases were misclassified as TY 2000 income. Three of these were estate fiduciary returns that were for the fiscal years ending in February and March 2001 and should have been processed with the TY 2001 information returns.

The IRS has few controls to ensure the accuracy of the Schedule K-1 data input to the Information Return database. Unlike the individual income tax returns on which, for example, wages, interest, dividends, etc., must add up to the total for "Adjusted Gross Income," there are no mathematical accuracy checks for Schedules K-1. In addition, the quality and managerial reviews that are conducted may find that an acceptable quality level exists without considering the trickle-down effect a small error rate can have on the Underreporter Program. Our own review of the accuracy of Schedule K-1 input found a 3.4 percent exception rate. Two reviews at the Ogden Submission Processing Center estimated error rates affecting the income item amounts of between 2.5 and 3.75 percent.

However, these relatively low rates, when applied to 14 million Schedules K-1, could mean that between 350,000 and 525,000 documents in the IRS' database may not be accurate. While not all of these will result in a notice to a taxpayer, a significant percentage will.

The IRS decided against entering Schedule K-1 data twice to ensure its accuracy. This duplicate entry of data is called key verifying and was done by the Ogden and Cincinnati Submission Processing Centers when they first began processing Schedules K-1. The IRS then decided to forgo key verifying because of the significant additional hours and related costs required to enter data twice for the millions of Schedules K-1. However, based on our review of the documentation supporting this decision, the IRS may have over estimated the additional costs involved and under estimated the impact on the Underreporter Program. Recommendation 3 on page 10 of this report could reduce the cost of processing Schedules K-1, freeing up funds to defray the cost of implementing controls to further improve the accuracy of information entered from paper Schedules K-1.

When the IRS takes other steps, such as those discussed on page 6, to improve the effectiveness of the Underreporter Program notice process, the result of the errors made while processing the paper Schedules K-1 will be further magnified.

Recommendation

2. The Director, Customer Account Services, SB/SE Division, should evaluate ways to effectively improve the accuracy of the Schedule K-1 information in the IRS' database. Training should emphasize areas of concern, such as processing Schedules K-1 to the correct year's database, and reviews should focus on areas that will prevent erroneous notices.

<u>Management's Response</u>: The Director, Customer Account Services, SB/SE Division, is working with IRS campuses to emphasize the need to correctly process the Schedule K-1 under the right tax year, and Schedule K-1 processing continues to be included in employee training classes. In addition, computer programming has been initiated to accept bar-coded Schedules K-1 for the purpose of data capture through scanning technology. The use of this technology will minimize inaccuracies and reduce the number of erroneously generated notices caused by input errors.

Improvements Could Be Made to the Schedule K-1 Matching Program by Increasing the Use of Electronic or Scannable Data

During Calendar Year 2001, the IRS manually entered data from approximately 14 million Schedules K-1 for use in its matching program. Manually entered data are subject to input errors. As discussed earlier, error rates affecting income item amounts entered from Schedules K-1 are estimated by one Submission Processing Center to be between 2.5 and 3.75 percent. Although relatively low, this error rate still results in many taxpayers receiving erroneous notices.

Data from Schedules K-1 received electronically or in scannable format will bypass the need for manual input by the IRS, and thus virtually eliminate IRS input errors and reduce processing costs. The Congress has set a goal for the IRS to receive 80 percent of all tax returns electronically by 2007, and in recent legislation[6] required partnerships having more than 100 partners to file electronically.

Changing the requirement for filing partnership returns electronically is one option for increasing the number of Schedules K-1 received by the IRS electronically. Estimates provided by an IRS analyst[7] showed that by lowering the requirement for electronic filing from more than 100 partners to more than 25 partners, an additional 1.6 million Schedules K-1 would be processed electronically. If the requirement were lowered to more than 10 partners, still another 1.8 million Schedules K-1 would be processed electronically. A second option to reduce the number of Schedules K-1 requiring manual entry involves electronically scannable Schedules K-1, which would use “2-dimensional bar codes.” Research into developing this scannable Schedule K-1 is in its early stages and has received little funding to date.

Mandating electronic filing of information tax returns needs to be carefully evaluated in terms of taxpayer burden. While individuals will be benefited through increased accuracy of the IRS’ Information Returns database and the

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[6] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 app.).
[7] Flow-through Entities Issue Specialist.

subsequent reduction in inaccurate notices, individual partnerships may incur additional burden or costs in meeting electronic filing requirements. However, we reviewed 97 of the partnership returns reporting income to taxpayers included in our samples and determined that the increased burden may not be significant. Thirty-seven of these partnership returns were for partnerships with more than 10 partners. Thirty-four (92 percent) of these 37 partnership returns with more than 10 partners were already prepared by paid tax professionals, so the additional burden of requiring these returns to be filed electronically would be minimal. Ten (27 percent) of the 37 partnerships also filed Employer's Annual Federal Unemployment Tax Returns (Form 940) and/or Employer's Quarterly Federal Tax Returns (Form 941). Of those 10 partnerships filing these forms, 4 (40 percent) filed them electronically.

The average net income of the 37 partnerships with more than 10 partners was over $16 million for TY 2000. We obtained tax data for 27 individual partners associated with these 37 partnerships, and calculated the average adjusted gross income for these partners to be $320,000. We researched and found that the cost to the taxpayer to electronically file a Web Based partnership return with fewer than 100 partners was $25. We had no data regarding any costs to taxpayers to prepare electronically scannable Schedules K-1.

Based on IRS estimates, if the 3.4 million Schedules K-1 currently being entered into IRS computers manually for partnerships with more than 10 partners were processed electronically, the IRS could reallocate approximately $3 million in processing costs to key verifying the remaining paper Schedules K-1 or developing other mathematical checks to ensure the accuracy of their input.

Recommendations

3. The Director, Compliance, SB/SE Division, should work with other operating divisions to determine the feasibility of a recommendation to the Department of the Treasury that electronic filing requirements for partnership returns be modified to include more

partnerships. This would be based on reducing the current 100-partner threshold for mandatory electronic filing to either 10 or 25 partners. If feasible, this recommendation should be elevated to the Department of the Treasury's Assistant Secretary for Tax Policy. If appropriate, future consideration should also be given to requiring S Corporation and Trust returns with a specific number of shareholders and beneficiaries to be filed electronically.

Management's Response: The Director, Compliance, SB/SE Division, will work with the Department of the Treasury to lower the current 100-partner threshold to 10 to 25 partners.

4. The Director, Customer Account Services, SB/SE Division, should provide staffing and resources to fully explore the potential value of scannable Schedules K-1.

Management's Response: The Director, Customer Account Services, SB/SE Division, has initiated computer programming to accept 2-Dimensional bar-coded Schedules K-1 for the purpose of data capture through scanning technology.

The Internal Revenue Service Should Carefully Consider What Improvements to Its K-1 Matching Program Can Be Achieved in the Near Term Before Proceeding With the Current Program

The IRS was originally going to focus on interest and dividends in the initial phase of its Schedule K-1 matching program. However, it subsequently decided to match other Schedule K-1 items as well. The IRS, on August 1, 2002, stopped issuing Schedule K-1 related Underreporter Program notices before meeting its planned total case review. Just prior to this, the Senate Committee on Small Business and Entrepreneurship sent a letter to the IRS Commissioner and the SB/SE Division Commissioner urging the IRS to "use caution in Schedule K-1 matching" because of the potential burden on small business owners.

For any Underreporter Program notice, there is the possibility that the income was properly reported and that a taxpayer/preparer will incur additional burden responding to the notice. Still, the compliance benefits of the program have to be evaluated and weighed against these inevitable burden issues. The Congress, in issuing the mandate to match these documents while expressing concerns about the burden to taxpayers, recognized the need for a proper balance between compliance and burden issues.

The IRS has collected data from this year's closed Schedule K-1 Underreporter Program cases and will try to determine possible enhancements to the program. It plans a review of various aspects of the program, including the accuracy of the screen-out process and the level of "no change" rates. The IRS stated it would be working closely with external stakeholders once the data gathering and analysis are completed to develop future policy and procedures for the K-1 matching program. The matching of TY 2001 returns will continue as scheduled, with anticipated refinements incorporated into the process.

Our review concentrated on causes for the unnecessary notices and did not look at cases where assessments were made. In addition, we limited our review because the IRS stopped issuing notices and committed to analyze the program. Finally, it is not known what program refinements will be made as a result of the IRS' analysis of this year's program. We do not have empirical data to recommend, nor are we recommending, that the IRS cancel its K-1 matching program for next year. However, a change to the Schedule E cannot be made before the TY 2002 tax returns are published, and any matching program in 2003 (which would match TY 2001 information) will still rely heavily on data entered manually into IRS computers. Given this, the IRS needs to carefully weigh the costs and benefits of the current Schedule K-1 matching program before proceeding with virtually the same program next year.

Recommendation

5. The Director, Compliance, SB/SE Division, should carefully consider the benefits of the program; the cost of entering the Schedule K-1 data into the computer, screening notices, and working "no change" cases; the costs to taxpayers who receive unnecessary or erroneous notices; and the enhancements that can be made to the program in the near future as a result of the IRS' analysis before it proceeds with a program to match all data from Schedules K-1 again in 2003.

<u>Management's Response</u>: The Director, Compliance, SB/SE Division, has conducted a review of over 3,200 cases and modified processing instructions to reduce no-change cases in the program.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether Internal Revenue Service (IRS) controls were effective in ensuring the accuracy of notices issued to taxpayers who may have underreported income from Schedules K-1[1] on their individual income tax returns.

To accomplish our objective, we:

I. Determined whether IRS controls were effective in ensuring the accuracy of Schedule K-1 data.

   A. Reviewed relevant Internal Revenue Manual sections to determine Automated Underreporter (AUR) matching and processing procedures.

   B. Discussed Schedule K-1 processing and matching procedures with IRS personnel.

   C. Reviewed AUR Schedule K-1 case tracking reports from the Ogden and Brookhaven IRS Campus AUR branches.

   D. Reviewed IRS processing and matching documentation.

II. Selected a judgmental sample of 50 "screened out" cases from the current inventory of cases (25 from Ogden and 25 from Brookhaven).

   A. Evaluated these cases to determine whether they were initially the result of: IRS input errors; IRS Underreporter Program errors; or Partnership, Fiduciary, or S Corporation reporting problems, such as amended returns or misclassified or misreported amounts.

   B. Determined whether the cases were appropriately "screened out."

   C. Determined whether the recommendation regarding making changes to an individual income tax schedule from our prior audit would have prevented the case.

III. Selected a judgmental sample of 50 notices issued to taxpayers where no assessment was made (25 from Ogden and 25 from Brookhaven).

   A. Evaluated the cases to determine whether they were the result of: IRS input errors; IRS Underreporter Program errors; or Partnership, Fiduciary, or

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

S Corporation reporting problems, such as amended returns or misclassified or misreported amounts.

B. Analyzed the sample of 50 "no change" cases to determine whether the recommendation from our prior Schedule K-1 audit regarding changes to an individual income tax return schedule would have prevented the case.

C. Determined whether the cases should have been "screened out" without having a notice issued.

D. Determined whether the 50 "no change" cases were properly "no changed."

E. Analyzed taxpayer demographics of the 100 individual income tax returns that had these Schedule K-1 related underreported income amounts.

IV. Reviewed the taxpayers' replies to notices from the sample of 50 "no change" cases to ensure the notices were easily understandable and accurate.

Sample Selection: The sample of cases reviewed was a judgmental selection of 100 cases (50 "screened out" and 50 "no change" cases) from the inventory of recently worked cases in the Underreporter function (25 from Ogden and 25 from Brookhaven for each type of case). We reviewed the cases from the case inventory as soon as they were available. Because of this sampling method, we did not have the entire population to select from and could not ensure a completely random selection. Case selection in Ogden was performed by selecting every n^{th} case based upon the total cases available at the time of selection. Several selections were made to obtain the desired sample size. An auditor from Brookhaven selected the sample of 50 cases by selecting every 32^{nd} case from a population of 816 cases for the "no change" cases and every 13^{th} case from a population of 345 cases for the sample of "screened out" cases. This sampling limitation was necessary for us to have the ability to provide feedback in a timely manner, which we determined to be a priority for this review. Accordingly, the sample as selected is not a statistically valid sample that we can rely on to make projections to the entire population.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Director, Customer Account Services, Small Business/Self-Employed Division S:CAS
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Director, Tax Forms and Publications, Wage and Investment Division W:CAR:MP:FP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaisons:
    Commissioner, Small Business/Self-Employed Division S
    Commissioner, Wage and Investment Division W

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Cost Savings (recommendations that funds be put to better use) - Potential; $3 million (see page 9).

Methodology Used to Measure the Reported Benefit:

The Internal Revenue Service (IRS) estimates that 3.4 million more Schedules K-1[1] would be processed electronically if partnership returns with more than 10 partners were required to file electronically. The IRS also estimates 18,148,400 Schedules K-1 will be processed during Fiscal Year 2003 at a cost of $16,055,091. This is 88.5 cents per return, or $3 million for 3.4 million returns. We have no figures for other flow-through entities (Trusts and S Corporations); however, if similar requirements were implemented for these entities, this cost savings figure would increase.

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

Appendix V

Schedule K-1[1] Related Underreporter Program Case Taxpayer Demographics

When data captured from taxpayer records indicate taxpayers reported less income on their individual income tax returns than payers reported on the information returns, an Underreporter Program case is generated. These cases are first screened by Internal Revenue Service (IRS) employees, who manually review the taxpayer's individual income tax return in an attempt to account for the unreported amounts. If the amounts are located, the case is closed or "screened out," and no action is taken. If the underreported amounts are not found on a taxpayer's return during screening, the IRS sends a notice to the taxpayer regarding the underreported income amounts. A taxpayer who is sent a notice as a result of an Underreporter Program case is given an opportunity to respond to the IRS to explain how the income has been accounted for on his or her individual income tax return. If a taxpayer's response adequately accounts for the income, the case is "no changed."

As part of our review of the 50 screened out and 50 "no change" cases mentioned in the report, we did additional analysis of the taxpayer demographics. We found the 100 individual income tax returns reviewed were professionally prepared 92 percent of the time. This figure includes four returns that were self-prepared by taxpayers that we considered professionals, namely Certified Public Accountants and attorneys. The benefit of knowing this is that any information related to the Schedule K-1 matching initiative that the IRS aims at the preparer community will be properly directed and could have a significant impact.

The average number of Schedules K-1 per individual taxpayer in our sample was 2.25 and ranged from 1 to 13. Seventy-six percent of the individual taxpayers identified by the Underreporter Program for Schedule K-1 issues had either one or two Schedule K-1 income sources. The majority (64 percent) of the Schedules K-1 in our reviews were from partnerships; 28 percent were from S Corporations; and 9 percent were from fiduciary returns (the percentages exceed 100 percent due to rounding).

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

Appendix VI

Management's Response to the Draft Report

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
FEB 26 2003

FEB 26 2003

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph G. Kehoe
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedules K-1 (Audit #200230033)

I have reviewed your report and agree we must make changes to the Schedule K-1 program. We have a cross-functional task force reviewing possible changes to the Schedule E, Supplemental Income and Loss, and Schedule K-1[1], under the guidance of the Taxpayer Burden Reduction Council and the Office of Taxpayer Burden. The goal is to simplify the forms, make them more easily subject to matching, and reduce taxpayer burden. We agree with your recommendations on providing staffing and resources to fully explore reducing notices to taxpayers in the Schedule K-1 program.

Additionally, we conducted a study of the cases within the Schedule K-1 program. As a result of the study, we changed our screening process. This change will eliminate some notices being sent to taxpayers. The change to the process will increase the cost of screening the work. However, the change should significantly reduce resources in the response phase of Automated Underreporter (AUR).

Our comments on the recommendations in this report follow.

RECOMMENDATION 1

The Director, Compliance, Small Business/Self Employed (SB/SE) Division, should work with the Director, Tax Forms and Publications, Wage and Investment Division, to make changes to the Form 1040, Schedule E. Consideration should be given to classifying and reporting pass-through income to facilitate easier comparisons to Schedules K-1 and make the matching program more effective and less subject to extensive manual screening.

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

ASSESSMENT OF CAUSE
The current forms do not facilitate easy comparison to Schedule K-1. These forms make the matching program less effective and subject to extensive manual screening.

CORRECTIVE ACTION
We have a cross-functional task force underway, headed by the Office of Burden Reduction, to revise the Schedule K-1 and Schedule E forms. The goal of the revision is to simplify these forms, make them more easily subject to matching, and reduce taxpayer burden. This revision will result in a proportionate reduction in Schedule K-1 errors and the notices associated with them. We are revising the Schedule E and instructions to more clearly define the appropriate use of netting and to provide additional explanation of discrepancies that may be found during IRS processing.

We have already changed the 2002 Form 8582, Passive Activity Loss Limitation, to require taxpayers to attach Form 8582 worksheets to the tax return. We have also instructed taxpayers to identify on the worksheets the lines on the tax return where they reported passive activity income and losses shown on those worksheets.

IMPLEMENTATION DATE
December 31, 2004

RESPONSIBLE OFFICIAL (S)
Director, Compliance, SB/SE Division

RECOMMENDATION 2
The Director, Customer Account Services, SB/SE Division, should evaluate ways to effectively improve the accuracy of the Schedule K-1 information in the IRS database. Training should emphasize areas of concern, such as processing Schedules K-1 to the correct year's database and reviews should focus on areas that will prevent erroneous notices.

ASSESSMENT OF CAUSE
There are few controls in place to ensure the accuracy of the Schedule K-1 data input to the Information Return database. Unlike the individual income tax returns, there are no mathematical accuracy checks for Schedule K-1.

CORRECTIVE ACTION
We are working with our campuses to re-emphasize the need to correctly process the Schedule K-1 under the right tax year. We continue to train our employees on portions of the Internal Revenue Manual (IRM) that focus on Schedule K-1.

Additionally, we recently submitted a Request for Information Services (RIS) that will allow the IRS to accept 2-Dimensional (2-D) bar coded Schedule K-1 documents for the purpose of data capture through scanning technology. The use of this technology will

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purpose of data capture through scanning technology. The use of this technology will minimize the inaccuracies and reduce the number of erroneously generated notices caused by input errors related to K-1 processing.

IMPLEMENTATION DATE
January 1, 2004

RESPONSIBLE OFFICIAL (S)
Director, Customer Account Services, SB/SE Division

RECOMMENDATION 3
The Director, Compliance, SB/SE Division, should work with other operating divisions to determine the feasibility of a recommendation to the Department of the Treasury that electronic filing requirements for partnership returns be modified to include more partnerships. This would be based on reducing the current 100-partner threshold for mandatory electronic filing to either 10 or 25 partners. If feasible, this recommendation should be elevated to the Department of the Treasury's Assistant Secretary for Tax Policy. If appropriate, future consideration should also be given to requiring S Corporation and Trust returns with a specific number of shareholders and beneficiaries to be filed electronically.

ASSESSMENT OF CAUSE
N/A

CORRECTIVE ACTION
We will work with the Department of the Treasury to lower the current 100-partner threshold to 10 to 25 partners.

IMPLEMENTATION DATE
January 1, 2005

RESPONSIBLE OFFICIAL (S)
Director, Customer Accounts Services, SB/SE Division

RECOMMENDATION 4
The Director, Customer Account Services, SB/SE Division should provide staffing and resources to fully explore the potential value of scannable Schedule K-1.

ASSESSMENT OF CAUSE
Due to budget constraints, we have limited funding to provide staff and resources to develop a scannable Schedule K-1.

CORRECTIVE ACTION
Customer Account Services, SB/SE submitted a Request for Information Services (RIS) that would allow the IRS to accept 2-Dimensional (2-D) bar coded Schedule K-1 documents to capture through scanning technology. If implemented, this would optimize resources needed to process all Schedule K-1.

IMPLEMENTATION DATE
January 31, 2004

RESPONSIBLE OFFICIALS)
Director, Customer Account Services, SB/SE Division

RECOMMENDATION 5
The Director, Compliance, SB/SE Division, should carefully consider the benefits of the program; the cost of entering the Schedules K-1 data into the computer, screening notices, and working "no change" cases; the costs to taxpayers who receive unnecessary or erroneous notices; and the enhancements that can be made to the program in the near term as a result of the IRS' analysis before it proceeds with a program to match all data from Schedules K-1 again in 2003.

ASSESSMENT OF CAUSE
N/A

CORRECTIVE ACTION
We conducted an extensive study to stratify the cause(s) of screenout, no-change, and agreed cases within the Schedule K-1 program. Over 3,200 cases were reviewed, and we identified reasons for closure for each case. As a result of this study, we identified many of the causes for no-change cases. We then modified our screening process, which should eliminate a large number of the no-change cases in the program. We are currently in the process of updating the screening criteria in the IRM.

IMPLEMENTATION DATE
March 31, 2003

RESPONSIBLE OFFICIAL (S)
Director, Compliance, SB/SE Division

If you have any questions, please call me, at (202) 622-0600, or a member of your staff may contact Joseph R. Brimacombe, Deputy Director, Compliance Policy, SB/SE at (202) 283-2200.