TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Internal Revenue Service Is Underutilizing Form 1099-K Data to Identify Tax Returns for Audit

September 29, 2017

Reference Number: 2017-30-083

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THE INTERNAL REVENUE SERVICE IS UNDERUTILIZING FORM 1099-K DATA TO IDENTIFY TAX RETURNS FOR AUDIT

Highlights

Final Report issued on September 29, 2017

Highlights of Reference Number: 2017-30-083 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

The latest estimate of the Tax Gap released by the IRS was $458 billion. The Tax Gap is the amount of taxes that are not paid voluntarily and timely. The IRS reported that a significant portion ($125 billion, or 27 percent) of the Tax Gap was attributed to underreporting of business income earned by entities other than corporations. The IRS also concluded that compliance with income reporting is higher when the income is subject to third-party reporting or withholding.

Congress enacted legislation in July 2008 requiring payment settlement entities to report payments made to merchants in settlement of payment card transactions. In response, the IRS developed Form 1099-K, *Payment Card and Third Party Network Transactions*, for submission by payment settlement entities starting in Calendar Year 2012. This information reporting was intended to assist the IRS in matching income from gross receipts to income reported on tax returns in an effort to reduce the Tax Gap. The Department of the Treasury estimated that enactment of this law would result in the collection of additional tax revenue of almost $10 billion over 10 years.

WHY TIGTA DID THE AUDIT

The IRS established the Payment Card Program in Calendar Year 2012 and developed the Payment Mix Methodology algorithm to compare Form 1099-K data to tax return data based on the assumption that similar businesses will have a comparable blend of cash and payment card purchases. This audit was initiated to determine whether the IRS is using merchant card third-party reporting (Form 1099-K) information in an effective manner for the assignment of productive audits.

WHAT TIGTA FOUND

The Payment Mix Methodology test (pilot) of the Payment Card Program was designed to select tax returns for audit based on Form 1099-K data. Although the IRS is considering discontinuing the pilot, it appears that the pilot was effective for certain types of tax returns. Additionally, the IRS appears to have missed opportunities to audit tax returns with large discrepancies between payments reported on Forms 1099-K and income reported on taxpayers' tax returns.

TIGTA reviewed a subset of taxpayers with one Form 1099-K and found a total of 20,881 taxpayers with discrepancies of more than $10,000 between income reported on their tax returns and their Form 1099-K amounts (and reporting less than 90 percent of the amount on the Form 1099-K). The tax accounts for these taxpayers had no indication of any audit activity.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS 1) consider implementing compliance projects to test the use of Form 1099-K data to identify certain types of tax returns for audit and 2) identify and address the reasons tax returns with large discrepancies between income reported on tax returns and the amounts reported on Forms 1099-K were not selected for audit or other treatment.

IRS management generally agreed with the recommendations and plans to take corrective actions, but disagreed with TIGTA as to the magnitude of the issue.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 29, 2017

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Is Underutilizing Form 1099-K Data to Identify Tax Returns for Audit
(Audit # 201630017)

This report presents the results of our review to determine whether the Internal Revenue Service is using merchant card third-party reporting information in an effective manner for the assignment of productive audits. This audit is included in our Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of Improving Tax Compliance.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Abbreviations

AC	Activity Code
DIF	Discriminant Function
FY	Fiscal Year
IRS	Internal Revenue Service
MCC	Merchant Category Code
PMM	Payment Mix Methodology
RA	Revenue Agent
TCO	Tax Compliance Officer
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TY	Tax Year

Background

The latest estimate of the Tax Gap, released by the Internal Revenue Service (IRS) in April 2016, was $458 billion.[1] The Tax Gap is the amount of taxes that are not paid voluntarily and timely. The size of the Tax Gap highlights the importance of the IRS's efforts to ensure that every taxpayer meets their tax obligations. The IRS reported that a significant portion ($125 billion, or 27 percent) of the Tax Gap was attributed to underreporting of business income earned by entities other than C corporations.[2] The IRS also concluded that compliance with income reporting is higher when the income is subject to third-party reporting or withholding.

The IRS instituted the Payment Card Program to determine the best approaches for using Form 1099-K data to identify potential underreporting that contributes to the Tax Gap.

Congress enacted legislation[3] in July 2008 adding Section 6050W to the Internal Revenue Code requiring payment settlement entities (payers)[4] to report payment transactions made to merchants (payees). The IRS developed Form 1099-K, *Payment Card and Third Party Network Transactions*, for submission by payment settlement entities starting in Calendar Year 2012 for Calendar Year 2011 reportable payment transactions. Each year, payers are required to provide Forms 1099-K to the IRS by February 28 if submitted by paper and by March 31 if submitted electronically.[5] This information reporting was intended to assist the IRS in matching income from gross receipts reported on Forms 1099-K to income reported on tax returns in an effort to reduce the Tax Gap. The Department of the Treasury estimated that enactment of this law would result in the collection of additional tax revenue of almost $10 billion over 10 years.

The IRS uses Form 1099-K to assist in comparing payee gross receipts from payment card sales to gross receipts reported on the taxpayer's tax return. Payment settlement entities must report the following types of payment transactions:

- Payment Card Transactions – A reportable payment card transaction involves a bank or other entity with a contractual obligation to make a payment to a merchant, in settlement

[1] Publication 1415, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008–2010*, (May 2016).
[2] A corporation that is taxed separately from its owners. The profit of a C corporation is taxed to the corporation when earned and distributed to shareholders as dividends.
[3] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654.
[4] "Payment settlement entity" as used in this document means the banks and other organizations with contractual obligations to make payments to participating payees (merchants) in settlement of payment card transactions or third-party network transactions.
[5] If the due date falls on a Saturday, Sunday, or legal holiday, Form 1099-K is considered timely if provided on the next business day.

of reportable payment card transactions, including credit cards, debit cards, and stored-value cards. The entity that transfers funds to the merchant's account is responsible for preparing and furnishing Form 1099-K to the merchant and to the IRS. All payers making one or more payments to a payee in settlement of reportable payment card transactions are required to file Forms 1099-K annually with the IRS.

- <u>Third-Party Network Transactions</u> – A third-party network transaction involves a third-party settlement organization. A third-party settlement organization has the contractual obligation to make payments to participating payees in a third-party payment network. The most common example of a third-party settlement organization is an online auction payment facilitator, such as PayPal,[6] which operates as an intermediary between a buyer and seller by transferring funds between accounts in settlement of an auction or purchase. Third-party settlement organizations charge a fee to sellers for facilitating the transaction. Under the reporting requirements, third-party settlement organizations must complete Form 1099-K when there are more than 200 transactions and payments to a payee exceed $20,000.

The law requires payers to report annual gross payment transactions to the IRS and send a written statement containing the same information to the participating payees that received these payments. For example, in payment card transactions, a payee that accepts payment cards will enter into a contract with a payer that has the contractual obligation to make payments to the payee in settlement of reportable payment card transactions. The payer reports the gross amount of such reportable payment transactions for the calendar year and for each month within that calendar year. The payer must also report the payee name, address, and Taxpayer Identification Number (TIN)[7] on Form 1099-K. A written statement must be furnished by the payer to the payee containing the same information as the Form 1099-K, which includes the name, address, and telephone number contact for the payer.

The IRS analyzes Form 1099-K data to identify basic errors, such as an invalid TIN. If an error is found, the IRS contacts the payer for the correct information. According to a prior Treasury Inspector General for Tax Administration (TIGTA) report,[8] in Calendar Year 2013, the IRS received 362,573 Forms 1099-K with more than $106 billion in gross transactions with incorrect payee TINs. TIGTA also found that payers were not always compliant with backup withholding requirements for payees that failed to provide a TIN.[9]

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[6] PayPal gives individuals and businesses a way to send money without sharing financial information and with the flexibility to pay using bank accounts and credit cards.
[7] A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the TIN can include an Employer Identification Number, a Social Security Number, or an Individual TIN.
[8] TIGTA, Ref. No. 2015-40-089, *Additional Actions to Enforce Payment Card Reporting Requirements Could Reduce the Tax Gap* (Sept. 2015).
[9] Backup withholding provisions require payers to withhold 28 percent of amounts reported on Forms 1099-K associated with payees that do not provide a payer with a TIN or provide an incorrect TIN.

This review was performed in the Small Business/Self-Employed Division Headquarters in Lanham, Maryland, and field offices in Laguna Niguel, California; Miami and Plantation, Florida; and Dallas, Texas, during the period November 2016 through June 2017. We conducted this performance audit 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

The Payment Mix Methodology (PMM) test (pilot) of the Payment Card Program was designed to select tax returns for audit based on Form 1099-K data. Although the IRS is considering discontinuing the pilot, it appears that the pilot was effective for certain types of tax returns. Additionally, the IRS appears to have missed opportunities to audit tax returns with large discrepancies between payments reported on Forms 1099-K and income reported on taxpayers' tax returns.

The Payment Mix Methodology Pilot Was Effective for Certain Types of Tax Returns

Because businesses may earn revenue by both cash and payment card purchases, it is not always possible to directly match the payment card receipts on Form 1099-K to the gross receipts shown on Form 1040, *U.S. Individual Income Tax Return*, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*. To assist in its efforts to reduce the underreporting of business income that contributes to the Tax Gap, the IRS developed the PMM algorithm to compare Form 1099-K data to tax return data based on the assumption that similar businesses will have a comparable blend of cash and payment card purchases. Outside contractors assisted in developing portions of the PMM, which incurred costs of more than $30 million from Calendar Years 2011 through 2016. Statistical methods were developed to select taxpayers for audit using parameters such as **2*************************************
********2**********

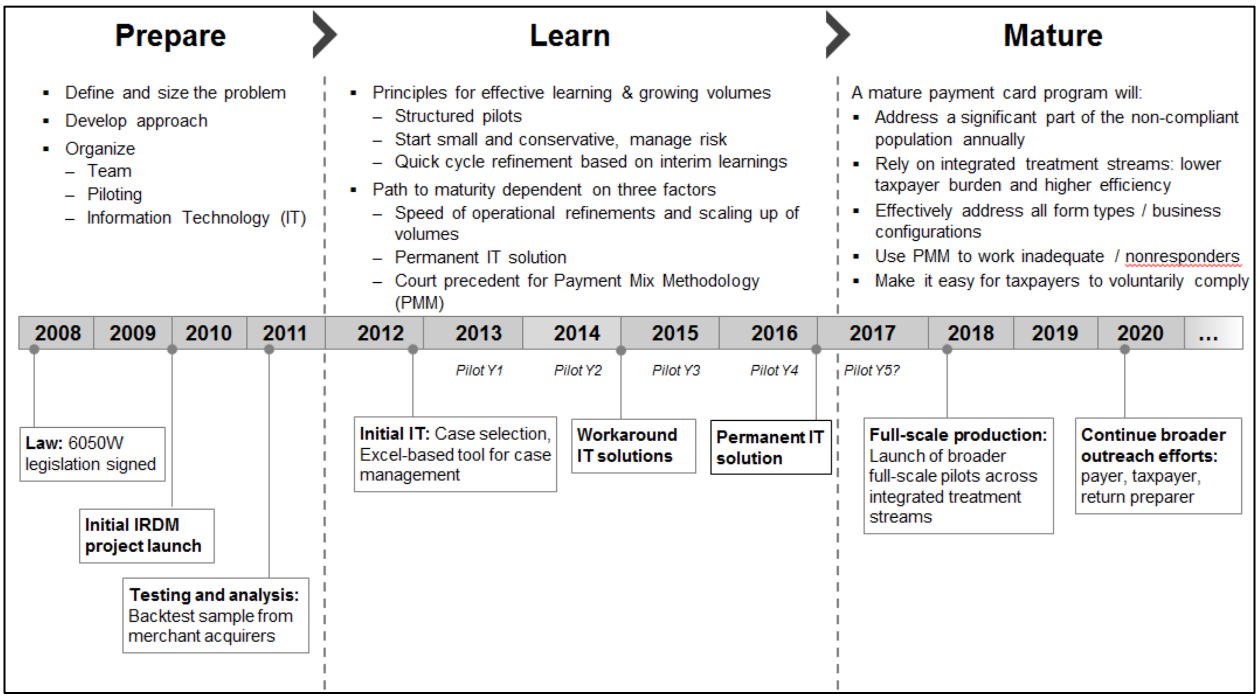
In simple terms, the PMM is the ratio of ***********2 and 7**********************
******** 2 and 7*******. ********2 and 7**********************, based on the ******************2 and 7**************[10]**********************. For example, the *********************************2 and 7***********************************
************2 and 7**************.[11] ***************2 and 7*********************
2 and 7** information, ***2 and 7*** information, and ***2 and 7** from the***2 and 7 ***. Potential underreported income is identified through the use of both the***2 and 7*****, and the amount of the potential underreported income is estimated**********2 and 7****
********2 and 7 ***************. By comparing similar businesses, the IRS sought to identify taxpayers with***********************2 and 7 *************************. Taxpayers that appear to have an**********************2 and 7 *********************,

[10] Four-digit code used by the payment card industry to classify the payee.
[11] This is a hypothetical example that is not drawn from any actual taxpayer's case.

**********2 and 7 ****************************, may be underreporting a portion of their gross receipts from other sources, *e.g.*, cash and checks.

The IRS used a multiyear, multitreatment "test and learn" approach to determine the best approaches for using Form 1099-K data to identify potential underreporting that contributes to the Tax Gap. In Calendar Year 2012, the overall Payment Card Program was established with the initial timeline shown in Figure 1.

Figure 1: Timeline for Payment Card Program



Source: March 31, 2014, Operational and Strategic Update. IRDM = Information Return Document Matching, which includes PMM. Y# = Year 1, Year 2, etc.

Some of the principles used in developing the PMM pilot program were:

- Address both cash and payment card underreporting by using the PMM to compare Form 1099-K data to tax return data. Preliminary IRS analysis of a subset of tax returns for the pilot program suggests that a significant portion, possibly as high as 90 percent, of small business gross receipts underreporting may involve cash payments.
- Test multiple treatment streams for underreporting, such as notices and correspondence audits in addition to typical field audits. For example, the IRS developed scalable notice

treatment streams that allow less complex cases to be resolved in Campus Examination,[12] while more complex cases are escalated to Field Examination.

- Leverage outreach to improve voluntary compliance, such as assisting taxpayers to correct Form 1099-K mismatches and provide guidance to information return preparers.

The IRS tested the following hypotheses in using the PMM to select tax returns to be audited in the pilot program:

- If the PMM could identify tax returns for audit that were more productive than audits of tax returns identified by other approaches, such as the Discriminant Function (DIF).[13]
- If the PMM could identify noncompliance that would otherwise go unaddressed, such as unreported cash in addition to payment card receipts.
- If the PMM approach would promote long-term compliance.

The IRS launched the following three pilot initiatives to test the case selection criteria supporting the PMM hypotheses. The IRS also used filters to evaluate filing patterns for information and tax returns.

1. Alternative Notice – Compliance cases were identified for filers of Form 1040 with Schedule C and Form 1120, *U.S. Corporation Income Tax Return*, with an associated Form 1099-K. This was considered an underreporter notice pilot and was designed to determine the gross receipts that should have been reported on the tax return. Notices were sent to individuals and businesses with potential underreporting of income to verify income reported on the tax return. More than 13,000 notices were sent to individual taxpayers and more than 8,000 notices were sent to business taxpayers for tax returns from Tax Years (TY)[14] 2011 to 2013.
2. Correspondence Technical Audit – Compliance cases were identified for filers of Form 1040 with Schedule C, Form 1120, and Form 1120-S, *U.S. Income Tax Return for an S Corporation*, with an associated Form 1099-K. This was considered an audit pilot to test the efficiency of working cases selected based on payment card data in a correspondence setting. The taxpayer's books and records were requested to verify the gross receipts reported on the income tax return.
3. Field Audit – Compliance cases were identified for filers of Form 1040 with Schedule C;

[12] Correspondence audits typically begin with the IRS mailing a computer-generated letter to a taxpayer that outlines the audit process, identifies one or more items on the tax return that are being questioned, and requests supporting information to resolve the questionable items.
[13] The DIF is a mathematical technique used to classify income tax returns as to audit potential.
[14] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

Form 1120; Form 1120-S; and Form 1065, *U.S. Return of Partnership Income*, with an associated Form 1099-K. This was considered an audit pilot with complex tax returns worked by tax compliance officers (TCO) or revenue agents (RA) in an office or field audit setting.

We interviewed a judgmental[15] sample of 12 RA audit group managers located in three geographic areas about their experiences with audits of tax returns selected for the PMM pilot program. Overall, one-third (four of 12) of the group managers assessed the productivity of their PMM pilot program audits as less or similar to DIF audits. One-half (six of 12) of the group managers reported that much of the analysis would have been done by their RAs as part of their minimum income probes. Four group managers did not express an opinion on the productivity of PMM audits or whether their RAs would have included the tests in their minimum income probes.

Minimum income probes are defined in the Internal Revenue Manual as "a set of analytical tests intended to determine whether the taxpayer accurately reported income."[16] The particular minimum income probes used in an audit will vary depending on the tax return type (business or nonbusiness) and the method of audit (office or field audit setting).[17] One income probe required for audits of business and nonbusiness individual tax returns is analyzing any information return documents[18] provided for the taxpayer to ensure that any business or investment income was included on the appropriate tax return. Because Form 1099-K data are information return documents, the minimum income probes for audits of tax returns should routinely include a reconciliation of the Form 1099-K information to the tax return.

We also reviewed a judgmental sample of 65 in-process PMM audits from the 12 group managers we interviewed as well as two statistical samples of PMM audits (30 Form 1040 tax returns and 30 Form 1120 tax returns) closed as no-change in Fiscal Year (FY)[19] 2015. Our review found that examiners generally followed the applicable PMM pilot program procedures, such as using and updating the PMM Data Capture Instrument,[20] and generally used Form 1099-K data in their audits.

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[15] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.
[16] Internal Revenue Manual 4.10.4.3 (Aug. 9, 2011).
[17] The IRS defines nonbusiness tax returns as individual tax returns with no attached business schedule(s), such as Schedule C or Schedule F. Business tax returns are all types of tax returns not meeting the definition of nonbusiness tax returns.
[18] Information return documents include Form 1099 series and Form W-2, *Wage and Tax Statement*, documents.
[19] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[20] Data collection instruments are tools used to collect specific information which is later used to validate or improve an organization's performance.

The PMM showed promise for certain tax return types

According to the IRS, as of June 2017, a significant number of PMM field audits had been completed, but the IRS had not finalized its evaluation about the future use of the PMM approach. Our analysis of selected productivity statistics for the program's field audits completed in FYs 2013 through 2016 showed mixed results when compared to the productivity of field audits of similar tax return types selected using the DIF. Figure 2 shows the comparison of results for primary and related field audits.[21]

Figure 2: Comparison of Productivity Statistics for PMM Audits to DIF Audits for Field Primary and Related Tax Returns Completed in FYs 2013 Through 2016

Average	TCO Form 1040		RA Form 1040		RA 1120		RA 1120-S		RA 1065	
	PMM	DIF	PMM	DIF	PMM	DIF	PMM	DIF	PMM	DIF
Assessment Per Tax Return	$12,103	$7,682	$11,886	$18,509	$10,973	$20,360	N/A	N/A	N/A	N/A
Assessment Per Hour	$764	$791	$377	$483	$244	$488	N/A	N/A	N/A	N/A
Hours Per Tax Return	15.8	9.7	31.5	38.3	45.0	41.7	40.9	43.2	43.1	45.5
Audit Cycle Days	304	214	284	254	328	240	273	261	280	278
No Change Rate	21.2%	7.9%	13.3%	14.3%	37.8%	35.8%	39.7%	46.1%	47.5%	62.5%

Source: TIGTA's analysis of IRS audit data. N/A = not applicable because adjustments to Forms 1120-S and 1065 tax returns do not result in assessments to the S-Corporation or partnership but flow through to the tax returns of shareholders or partners.

Because related tax returns may not be selected for audit unless the primary tax return will have an adjustment, related tax returns often have better productivity statistics. Figure 3 shows our comparison of results for audits of only primary tax returns.

[21] Related audits are tax returns that may be selected for audit when they involve issues or transactions with other taxpayers, such as business partners or investors, whose tax returns were selected for audit. Primary audits are the originally selected tax returns.

Figure 3: Comparison of Productivity Statistics for PMM Audits to DIF Audits for Field Primary Tax Returns Completed in FYs 2013 Through 2016

Average	TCO Form 1040		RA Form 1040		RA 1120		RA 1120-S		RA 1065	
	PMM	DIF	PMM	DIF	PMM	DIF	PMM	DIF	PMM	DIF
Assessment Per Tax Return	$11,322	$7,418	$9,678	$13,257	$8,802	$14,571	N/A	N/A	N/A	N/A
Assessment Per Hour	$646	$710	$195	$281	$170	$298	N/A	N/A	N/A	N/A
Hours Per Tax Return	17.5	10.4	49.6	47.2	51.7	48.9	49.9	52.4	50.7	51.6
Audit Cycle Days	322	211	375	276	362	242	293	261	294	274
No Change Rate	25.6%	9.0%	25.4%	22.0%	49.5%	48.7%	54.1%	63.7%	60.3%	77.6%

Source: TIGTA's analysis of IRS audit data. N/A = not applicable because adjustments to Forms 1120-S and 1065 tax returns do not result in assessments to the S-Corporation or partnership but flow through to the tax returns of shareholders or partners.

Although the IRS has not made a final decision on how to use Form 1099-K information in future audits, our analysis of selected PMM audit productivity data by Activity Codes (AC)[22] ***********************************2 and 7***************************** ***********************************2 and 7******************************** ***********************************2 and 7 ********************************* ***********************************2 and 7**************************** ********************************2 and 7*****************, with fewer examiner hours per tax return and lower no-change rates. Figure 4 shows the comparison of recent productivity statistics for PMM and DIF audits of primary tax returns by RAs for Forms 1120-S in ACs 234, 288, and 289, and Forms 1065 in ACs 481 and 482 (more favorable PMM statistics shaded in grey).

[22] An AC identifies the type and condition of tax return selected for audit.

Figure 4: Comparison of Productivity Statistics for RA Audits of Primary Forms 1120-S and 1065 for Selected ACs, FYs 2015 Through 2016

Average	Form 1120-S AC 234[23]		Form 1120-S AC 288[24]		Form 1120-S AC 289[25]		Form 1065 AC 481[26]		Form 1065 AC 482[27]	
	PMM	DIF	PMM	DIF	PMM	DIF	PMM	DIF	PMM	DIF
Hours Per Tax Return	48.0	42.3	**49.2**	55.1	**52.6**	59.1	**43.8**	52.3	**51.6**	61.0
Audit Cycle Days	277	255	295	294	275	273	**263**	284	**289**	310
No Change Rate	**32.0%**	38.2%	**51.3%**	52.9%	**63.6%**	70.4%	**58.9%**	72.6%	**59.7%**	76.4%

Source: TIGTA's analysis of IRS audit data.

The PMM pilot audits also gave the IRS knowledge about the types of potential noncompliant taxpayers receiving Forms 1099-K. For example, our analysis of completed FYs 2013 through 2016 audits for TYs 2012 through 2014 showed the following MCCs on the taxpayers' Forms 1099-K were among the most common and productive for agreed assessments:

- ***********2******************.
- ****************2**********************.
- ***************2*********************.
- *****************************2*********************.

Because using Form 1099-K information to select certain types of tax returns has resulted in productive audits, the IRS should explore ways to continue using these data to reduce the Tax Gap, regardless of whether the PMM pilot is continued.

[23] Audits of tax returns for S Corporations with no balance sheet or no income.
[24] Audits of tax returns for S Corporations with assets less than $200,000.
[25] Audits of tax returns for S Corporations with assets from $200,000 to $9,999,999.
[26] Audits of tax returns for partnerships with 10 or fewer partners and gross receipts less than $100,000.
[27] Audits of tax returns for partnerships with 10 or fewer partners and gross receipts of $100,000 or more.

Recommendation

Recommendation 1: The Director, Examination, Small Business/Self-Employed Division, should consider implementing compliance projects to test the use of Form 1099-K data to identify certain types of tax returns for audit.

> ***Management's Response:*** IRS management agreed with this recommendation. The IRS plans to complete its analysis and evaluation of the PMM tests, including results from a current compliance initiative project[28] on flow-through entities (Forms 1120-S and 1065) to assess how to best use Form 1099-K data to select tax returns for audits.

The Internal Revenue Service Appears to Have Missed Opportunities to Audit Tax Returns With Large Discrepancies Between Payments Reported on Forms 1099-K and Income Reported on Taxpayers' Tax Returns

The IRS spent considerable effort developing the PMM algorithm to select tax returns based on Form 1099-K data but did not consider more obvious examples of noncompliance, *i.e.*, those in which taxpayers reported significantly less in gross revenue on their tax returns than the total amount of gross receipts reflected in Form 1099-K data. In using the PMM algorithm to select tax returns for audit, the IRS appears to have overlooked a significant number of questionable tax returns that could have been identified through a less complicated approach of matching Form 1099-K data to amounts reported on tax returns.

Comparing Form 1099-K data to tax return data can be complicated for taxpayers that receive multiple Forms 1099-K for one tax year or report income on multiple forms and schedules, such as Schedule C; Schedule E, *Supplemental Income and Loss*; or Schedule F, *Profit or Loss From Farming*. However, to reduce matching complexity, we compared TY 2014 Form 1099-K data to TY 2014 tax return data for Form 1040 taxpayers with only one Form 1099-K and one Schedule C and with no Schedule E or Schedule F. Our comparison found almost 5,021 TY 2014 tax returns that showed a discrepancy of more than $10,000 between the gross amount of payments on the Form 1099-K and the amount shown for gross receipts and other income on Schedule C. We did a similar comparison for corporation and partnership taxpayers that had one TY 2014 Form 1099-K and found 15,860 tax returns with a discrepancy of more than $10,000 between the gross amount of payments on the Form 1099-K and the amount shown for receipts on Forms 1120, 1120-S, or 1065.

[28] Projects characterized by the use of internal or external data to identify, quantify, evaluate, and correct areas of noncompliance. They usually involve a study or other analysis of a group of individuals such as those within an industry, specific economic activity, or event.

To allow for taxpayers that may have incorrectly entered a net amount of payments on their tax return (such as by deducting refunds for unwanted products or payment card fees), our comparison excluded taxpayers that included more than 90 percent of the Form 1099-K gross payment amount on their tax form even though the total difference was more than $10,000. Figure 5 shows that a total of 20,881 taxpayers had discrepancies of more than $10,000 between income reported on their tax returns and their Form 1099-K amount and also reported less than 90 percent of the amount on the Form 1099-K.

Figure 5: TY 2014 Tax Returns With More Than $10,000 Difference Between Form 1099-K Payment Amount and Income Reported on Tax Return (Less Than 90 Percent of Form 1099-K Amount Reported)

Potential Underreported Form 1099-K Amount	Type of Tax Return Filed by Taxpayer				Total Number of Taxpayers
	Form 1040	Form 1120	Form 1120-S	Form 1065	
$10,001 to $25,000	1,984	220	1,766	971	**4,941**
$25,001 to $100,000	2,168	333	3,490	1,687	**7,678**
$100,001 to $500,000	718	353	3,242	1,428	**5,741**
$500,001 to $1 million	80	72	734	277	**1,163**
$1,000,001 to $10 million	64	85	797	320	**1,266**
$10,000,001 to $100 million	7	13	38	26	**84**
More than $100 million	0	0	3	5	**8**
TOTAL	**5,021**	**1,076**	**10,070**	**4,714**	**20,881**

Source: TIGTA's analysis of IRS data.

The tax accounts for the taxpayers in Figure 5 had no indication of audit or Criminal Investigation activity. We also confirmed that none were selected for any alternative notice treatment or filed amended tax returns. According to the IRS, approximately 18,000 of the tax returns we identified were considered but not selected by its Automated Underreporter[29] program for a variety of reasons. The IRS has not determined why the remaining tax returns (more than 2,800) were not considered.

[29] The Automated Underreporter program matches taxpayer income and deductions submitted on information returns by third parties, *e.g.*, employers, banks, brokerage firms, against amounts reported by taxpayers on their individual income tax returns to identify discrepancies.

Some discrepancies may be due to input errors by payers on the Form 1099-K or by taxpayers on their tax forms. Data transcription errors by the IRS could also be responsible for some discrepancies. However, without contacting taxpayers through a notice or initiating an audit, the IRS cannot determine the reasons for the discrepancies between the amounts reported on Form 1099-K and the income reported on tax returns.

Recommendation

Recommendation 2: The Director, Examination, Small Business/Self-Employed Division, should identify and address the reasons tax returns with large discrepancies between income reported on tax returns and the amounts reported on Form 1099-K were not selected for audit or other treatment.

> ***Management's Response:*** IRS management generally agreed with this recommendation, but believes the magnitude of the issue is overstated. Of the 20,881 discrepancy cases identified by TIGTA, the IRS stated that it had identified the reasons why 18,053 were not selected for audit or other treatment, such as additional information indicating that the cases would not be productive. However, the IRS is planning to analyze its requirements and selection processes to determine why the remaining 2,828 discrepancy cases identified by TIGTA were not selected for audit or other treatment.
>
> ***Office of Audit Comment:*** For most of the 18,053 cases that were not selected for audit or other treatment, the explanations the IRS provided for not reviewing the discrepancies do not appear to be related to additional information on the potential productivity of the returns. For example, the IRS stated that more than 5,100 (28 percent) of the 18,053 discrepancies had been excluded from further underreporter treatment because of possible use in the PMM pilot (although none were ultimately selected for a PMM audit); and more than 6,600 discrepancies (37 percent) were forwarded to the Small Business/Self-Employed Division Field Case Selection for audit consideration and potential development of a compliance initiative project, but none were ultimately selected for an audit. More than 5,200 discrepancies (29 percent) were reported as removed from further underreporter treatment and not selected for audit, but we were not provided information on whether the criteria was related to the potential productivity of the tax returns. Taxpayers with significantly more Form 1099-K income than gross income reported on their tax return should receive attention from the IRS. Although the IRS has agreed to determine why approximately 2,800 discrepancies were not identified by its systems, we believe that this analysis should extend to all of the large discrepancies we identified that were not resolved by an IRS compliance process to ensure that future large discrepancies are not overlooked.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS is using merchant card third-party reporting information in an effective manner for the assignment of productive audits. To accomplish our objective, we:

I. Determined the process and procedures for using merchant card information in identifying potentially underreported income on tax returns.

   A. Reviewed IRS written procedures, training materials, and the status of ongoing initiatives for using merchant card information to identify and audit tax returns that may contain underreported income.

   B. Obtained IRS documentation and discussed with IRS officials the overall Payment Card Program methodology used to select tax returns for audit using merchant card information, including the use of outside contractors.

   C. Reviewed prior TIGTA reports concerning past review results and recommendations for how the IRS is using merchant card information.

II. Determined whether IRS field managers considered the use of merchant card information during audits to be beneficial and whether examiners were following procedures.

   A. Obtained and analyzed IRS lists for 6,571 Form 1040, *U.S. Individual Income Tax Return*, PMM audits for 3,318 taxpayers, and 427 Form 1120, *U.S. Corporation Income Tax Return*, PMM audits for 225 taxpayers, in process as of November 30, 2016, by 318 field groups to select a judgmental sample[1] of 12 group managers based on case volume and common office location. We validated that these data were reliable for our purposes by comparing the information in a judgmental sample of 10 PMM audits each for Forms 1040 and Forms 1120 to IRS source data on the Integrated Data Retrieval System.[2]

   B. Interviewed the sample of group managers selected in Step II.A. for the process and potential benefit of using merchant card information during audits.

[1] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.
[2] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

C. Selected and reviewed a judgmental sample of 65 PMM audits for 30 taxpayers from the 287 in process PMM audits for 138 taxpayers within the interviewed group managers' groups to determine whether procedures were being followed.

III. Assessed the productivity of the PMM Field audits.

A. Obtained the IRS productivity statistics, *i.e.*, dollars per tax return, dollars per hour, hours per tax return, audit cycle time, and no-change rate, for FYs[3] 2013 through 2016. In addition, we obtained the IRS coding criteria for the Audit Information Management System[4] to identify closed audits completed by TCOs of Form 1040 tax returns and by RAs of Forms 1040, 1120, 1120-S, *U.S. Income Tax Return for an S Corporation*, and 1065, *U.S. Return of Partnership Income*, tax returns.

B. Identified PMM and DIF audits completed during FYs 2013 through 2016 by TCOs of Form 1040 tax returns and by RAs of Forms 1040, 1120, 1120-S, and 1065 tax returns using Audit Information Management System data to calculate and compare productivity statistics for each tax return type by totals and by ACs. We validated calculated productivity statistics were reliable for our purposes by comparing with available IRS statistical information and provided the methodology to the IRS for review.

C. Identified primary PMM and DIF completed audits by removing related audits identified in Step III.B. to calculate and compare primary productivity statistics for each tax return type by totals and AC. We validated calculated productivity statistics were reliable for our purposes by comparing with available IRS statistical information and provided the methodology to the IRS for review.

D. Computer matched PMM completed audits identified in Step III.B. with TYs[5] 2012 through 2014 IRS Information Returns Processing data to identify coding on Forms 1099-K for type of payee business using the MCC. We analyzed the matched data by tax return type, *i.e.*, TCOs for Form 1040 tax returns and RAs for Forms 1040, 1120, 1120-S, and 1065 tax returns, to determine if certain types of Forms 1099-K yielded better no-change audit productivity measures. We validated these data were reliable for our purposes by comparing with available IRS statistical information and provided the methodology to the IRS for review.

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[3] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[4] An IRS computer system used to control audits, input assessments/adjustments to tax accounts, and provide management reports.
[5] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

IV. Assessed the effectiveness of PMM case selection for Field audits.

A. Used FY 2015 closed Audit Information Management System data to identify the sample universe of 1,084 Forms 1040 and 1,161 Forms 1120 Field audits closed as no-change and selected statistical random samples from each type. We validated these data were reliable for our purposes by comparing population totals with available IRS information. To balance time and resources, we used a confidence level of 95 percent with an error rate of 15 percent and a precision rate of ±8 percent so that approximately 72 sample tax returns were selected for each sample. We consulted with our contract statistician on our sampling methodology, including the possibility of stopping either review after 30 samples without exceptions.

B. Obtained audit case files for the samples selected in Step IV.A. and reviewed the cases using PMM procedures and training materials to determine if examiners followed guidance.

V. Assessed Form 1099-K, tax return, and tax account data to determine if the IRS may have missed opportunities in the PMM case selection process.

A. Obtained TY 2014 IRS Information Returns Processing data for all Forms 1099-K and identified payees that had only one Form 1099-K. We validated these data were reliable for our purposes by scanning the data for valid field values and comparing the information in a judgmental sample of 10 records to IRS source data on the Integrated Data Retrieval System, as well as the additional validation in Step V.D.

B. Computer matched payees that had only one TY 2014 Form 1099-K identified in Step V.A. with their TY 2014 tax return data to identify potential underreporting of gross receipts based on payees, *i.e.*, taxpayers, reporting less than 90 percent of gross receipts on tax returns than shown on Form 1099-K with a difference of more than $10,000. Taxpayers may have filed Forms 1040, 1120, 1120-S, or 1065 tax returns. To reduce matching complexity, we excluded taxpayers that filed a fiscal year tax return or submitted an amended tax return and excluded Form 1040 taxpayers that filed multiple Schedules C or a Schedule E or F. We validated these data were reliable for our purposes by comparing the information in a judgmental sample of 10 records for Forms 1040 and a judgmental sample of five records each for Forms 1120, 1120-S, and 1065 to IRS source data on the Integrated Data Retrieval System, as well as the additional validation in Step V.D.

C. Computer-matched potential underreporting taxpayers identified in Step V.B. with their tax account data to exclude those with current or past IRS compliance activity for audit, underreporter, or Criminal Investigation. In addition, we excluded taxpayers that received a notice. We validated these data were reliable for our purposes by comparing the information in a judgmental sample of 10 records for Forms 1040 and a judgmental sample of five records each for Forms 1120, 1120-S, and 1065 to IRS source data on the Integrated Data Retrieval System, as well as the additional validation in Step V.D.

D. Reviewed at least 30 randomly selected taxpayers identified in Step V.C. for each tax return type, *i.e.*, Forms 1040, 1120, 1120-S, or 1065, to validate the Form 1099-K, tax return, and tax account data used to identify potential underreporting taxpayers without IRS compliance activity were reliable for our purposes. We provided our final results for potential missed opportunities in the PMM case selection process and the methodology to the IRS for review.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: IRS processes and procedures to use merchant card information for identifying potentially underreported income on tax returns. We evaluated the controls by reviewing written procedures, training materials, status reports of ongoing initiatives, and overall Payment Card Program documentation, and holding discussions with IRS officials.

Appendix II

Major Contributors to This Report

Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Glen Rhoades, Director
Robert Jenness, Audit Manager
Gregory Helias, Lead Auditor
Aaron Foote, Senior Auditor
William Tran, Senior Auditor
Ali Vaezazizi, Auditor

Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Director, Examination, Small Business/Self-Employed Division
Director, Office of Audit Coordination

Appendix IV

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

SEP 05 2017

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy Mary Beth Murphy
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Internal Revenue Service is Underutilizing Form 1099-K Data to Identify Tax Returns for Audit (Audit # 201630017)

Thank you for the opportunity to review and comment on the subject draft report. We appreciate your acknowledgement of the efforts the IRS has taken to increase compliance with the reporting of income when subject to third-party reporting or withholding. As mentioned in your report, the IRS developed Form 1099-K, *Payment Card and Third Party Network Transactions*, for submission by payment settlement entities starting in Calendar Year 2012. The third-party information reporting assists IRS in matching income from sales to income reported on tax returns and continues to be utilized in the following SB/SE compliance efforts.

We incorporated the Form 1099-K into the automated document matching programs during 2013 by comparing the Form 1099-K data with tax returns. A notice is sent if card receipts are greater than amounts reported on the tax return. During traditional field examination audits, examiners reconcile Information Return Processing (IRP) documents to the tax return. As part of the minimum income probe requirements, the examiners analyze income and the corresponding information returns to ensure items reflected on the IRP documents are properly accounted for on the tax return. Examiners evaluate the Form 1099-K as a data source as they do with Form 1099-MISC, Miscellaneous Income. We continue to work with our Research, Applied Analytics, & Statistics group to apply insights learned from the Payment Mix Method test (pilot) results and findings as part of our broader Form 1099-K compliance efforts.

Although we generally agree with the recommendations in your report, we believe your second finding overstates the magnitude of the issue. With respect to TIGTA's sample cases, we not only identified the same discrepancies, but for the vast majority of those cases also identified the reasons why we did not ultimately select cases for additional treatment, e.g. additional available information indicated that they would not be as productive as they otherwise appeared. Of the 20,881 discrepancy cases identified by

TIGTA, we identified the reason why 18,053 were not selected for audit or other treatment.

Attached is a detailed response outlining our corrective action to address your recommendations. If you have any questions, please contact me, or a member of your staff may contact Brenda Dial, Director, Examination, SB/SE Division at (240) 613-2849.

Attachment

Attachment

RECOMMENDATION 1:
The Director, Examination, Small Business/Self-Employed Division, should consider implementing compliance projects to test the use of Form 1099-K data to identify certain types of tax returns for audit.

CORRECTIVE ACTION:
The IRS will complete its analysis and evaluation of the Payment Mix Method (PMM) tests including results from a current compliance initiative project (CIP) on flow-through entities (Forms 1120S and 1065), to assess how to best use Form 1099-K for return selection.

IMPLEMENTATION DATE:
October 15, 2018

RESPONSIBLE OFFICIAL:
Director, Examination Case Selection, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:
The Director, Examination, Small Business/Self-Employed Division, should identify and address the reasons tax returns with large discrepancies between income reported on tax returns and the amounts reported on Form 1099-K were not selected for audit or other treatment.

CORRECTIVE ACTION:
SB/SE currently has information return document matching functions that identify taxpayers with potential underreported income and exclude some discrepancy returns from audit or other treatment based on additional factors. As part of the implementation of the Payment Card legislation, these functions now include Forms 1099-K discrepancies. Of the 20,881 discrepancy cases identified by TIGTA, we identified the reason why 18,053 were not selected for audit or other treatment. We will analyze our requirements and the selection processes to determine why the remaining 2,828 cases were not considered to ensure selection of the best information return cases while balancing available resources. The implementation date for this action is based on the information technology resources that are needed to execute this corrective action.

IMPLEMENTATION DATE:
October 15, 2018

2

RESPONSIBLE OFFICIAL:
Director, Examination Case Selection, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.