The Use of Schedule K-1 Data to Address Taxpayer Noncompliance Can Be Improved

September 27, 2019

Reference Number: 2019-30-078

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HIGHLIGHTS

THE USE OF SCHEDULE K-1 DATA TO ADDRESS TAXPAYER NONCOMPLIANCE CAN BE IMPROVED

Highlights

Final Report issued on September 27, 2019

Highlights of Reference Number: 2019-30-078 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

The IRS conducts a Tax Gap study periodically to determine the nature and extent of taxpayer noncompliance to assist in formulating tax administration strategies. The last study, completed in April 2016, estimated the amount of tax liability not paid voluntarily and timely was $458 billion annually for Tax Years 2008 through 2010. The nonfiling portion of the Tax Gap is estimated to be $32 billion annually, while the underreporting portion is $387 billion annually, and the underpayment portion is $39 billion annually.

The Tax Gap study also found that noncompliance varies with the amount of information reporting by third parties (*e.g.*, employers, banks, partnerships). Items subject to substantial information reporting and withholding (*e.g.*, wages) have a misreporting rate of 1 percent for the individual income tax, while the misreporting rate for items subject to lesser degrees of information reporting are considerably higher.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the IRS uses Schedule K-1 data effectively to identify taxpayers not submitting tax returns or taxpayers underreporting tax while also minimizing unnecessary notices to taxpayers. Schedules K-1 are used by flow-through entities to report recipients' allocated share of income, deductions, credits, and other amounts. Unlike other information returns, Schedules K-1 are not submitted directly to the IRS, but are attachments to flow-through returns submitted on paper or by electronic filing. *****2***** **************2************** Schedules K-1 will limit the IRS's ability to identify potential noncompliance, resulting in the loss of tax revenue and inequitable treatment of taxpayers as well as potentially creating unnecessary work and increasing taxpayer burden.

WHAT TIGTA FOUND

TIGTA found that improvements are needed with the IRS's process design and collection of Schedule K-1 data to strengthen efforts to address the noncompliance of nonfilers and underreporters. Specifically, TIGTA found that the IRS: 1) annually accepts flow-through returns with approximately 3 million ****2**** ************2*************** Schedules K-1; 2) did not identify approximately 4,000 nonfilers who received $25,000 or more of Schedule K-1 income; and 3) could improve identification of underreporter noncompliance.

WHAT TIGTA RECOMMENDED

TIGTA made 11 recommendations to the Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, to improve the IRS's processes for collecting and using Schedule K-1 data.

The IRS agreed with 10 of 11 recommendations. Management stated that its disagreement with the recommendation to enhance the information return verification process to consider the date of death was due to its minimal benefit and significant programming changes. TIGTA contends that implementation of this recommendation would improve the IRS's ability to check tax compliance by better identifying the actual recipients of Schedules K-1.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 27, 2019

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Use of Schedule K-1 Data to Address Taxpayer Noncompliance Can Be Improved (Audit # 201730020)

This report presents the results of our review to determine whether the Internal Revenue Service uses Schedule K-1 data effectively to identify taxpayers not submitting tax returns or taxpayers underreporting tax while also minimizing unnecessary notices to taxpayers. This review is included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management challenge of Improving Tax Reporting and Payment Compliance.

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

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

AUR	Automated Underreporter
BUR	Business Underreporter
CCNIP	Case Creation Nonfiler Identification Process
CY	Calendar Year
E-File(d), E-Filing	Electronically File(d), Electronic Filing
GMF	Generalized Mainline Framework
IRMF	Information Returns Master File
IRS	Internal Revenue Service
MeF	Modernized e-File
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TY	Tax Year

Background

The Internal Revenue Service (IRS) conducts a Tax Gap study periodically to determine the nature and extent of noncompliance to assist in formulating tax administration strategies. The last study, completed in April 2016, estimated that the amount of tax liability not paid voluntarily and timely was $458 billion annually for Tax Years (TY) 2008 through 2010.[1] The Tax Gap is comprised of taxpayers not providing tax returns to establish liabilities (nonfiling), taxpayers misreporting amounts used to calculate liabilities (underreporting), and taxpayers not paying liabilities reported on timely filed tax returns (underpayment). The nonfiling portion of the Tax Gap is estimated to be $32 billion annually, while the underreporting portion is $387 billion annually, and the underpayment portion is $39 billion annually.

The Tax Gap study also found that noncompliance varies with the amount of information reporting by third parties (*e.g.*, employers, banks, partnerships). Items subject to substantial information reporting and withholding (*e.g.*, wages) have a misreporting rate of 1 percent for the individual income tax. However, the misreporting rate for items subject to some information reporting (*e.g.*, partnership income) is 19 percent, and the misreporting rate for items subject to little or no information reporting (*e.g.*, proprietor income) is 63 percent.

There are over 50 types of information reporting forms, which include Schedules K-1 used by flow-through entities (estates/trusts, partnerships, and S Corporations) to report recipients' (beneficiaries, partners, and shareholders) allocated share of income, deductions, credits, and other amounts. Unlike other information returns, Schedules K-1 are not submitted directly to the IRS but are attachments to flow-through returns submitted on paper or by electronic filing (e-filing). Figure 1 shows the various flow-through returns with applicable Schedules K-1.

[1] A tax year is a 12-month accounting period used for calculating annual tax information. For most individual taxpayers, the tax year is synonymous with the calendar year.

Figure 1: Flow-Through Returns and Schedules K-1

Flow-Through Return	Schedule K-1
Form 1041, *U.S. Income Tax Return for Estates and Trusts*	Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*
Form 1065, *U.S. Return of Partnership Income*	Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*
Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*[2]	Schedule K-1 (Form 1065-B), *Partner's Share of Income (Loss) From an Electing Large Partnership*
Form 1120S, *U.S. Income Tax Return for an S Corporation*	Schedule K-1 (Form 1120S), *Shareholder's Share of Income, Deductions, Credits, etc.*
Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*[3]	Schedule K-1 (Form 8865), *Partner's Share of Income, Deductions, Credits, etc.*

Source: IRS forms and instructions for Forms 1041, 1065, 1065-B, 1120S, and 8865.

Original and amended Schedules K-1 submitted on paper are scanned using the Service Center Recognition/Image Processing System.[4] However, only certain lines, called transcribed lines, are electronically recorded for future IRS review. Prior to Processing Year 2018, Schedules K-1 for tax years prior to the current tax year were not scanned, and Schedules K-1 for the current tax year submitted after a predetermined cutoff date in December were not scanned.[5] Starting in Processing Year 2018, the predetermined cutoff date was changed so that all Schedules K-1 submitted for the current tax year and ***2****tax years will be scanned. After scanning, employees compare the paper Schedule K-1 to the scanned image before sending Schedule K-1 transcribed lines to the Generalized Mainline Framework (GMF), the computer system that processes tax forms and tax-related data.[6]

E-filed original and amended Schedules K-1 are received by the Modernized e-File (MeF) system.[7] Flow-through returns and attachments, including Schedules K-1, are either accepted or rejected as a group using MeF business rules that are available to the public. If rejected, the

[2] The Bipartisan Budget Act of 2015 (Pub. L. No. 114-74, 129 Stat. 584) repealed the electing large partnership rules for tax years beginning after December 31, 2017; therefore, Form 1065-B and its applicable Schedule K-1 will no longer exist. Form 1065-B was included to display forms associated with Schedules K-1 but will not be discussed further in this report.

[3] Form 8865 is not a "stand alone" flow-through return submitted to the IRS. It and its applicable Schedules K-1 are attachments to the partner's return that could be an individual, corporate, or another flow-through return. Form 8865 was included to display forms associated with Schedules K-1 but will not be discussed further in this report.

[4] The Service Center Recognition/Image Processing System is a data capture, management, and storage system that uses high-speed scanning and digital imaging technology to process tax documents.

[5] A processing year refers to the calendar year in which the tax return or document is processed by the IRS. For example, most individual TY 2018 tax returns will be processed in Calendar Year 2019, which is Processing Year 2019. For Processing Year 2017, the cutoff date was December 13, 2017, for TY 2016 Schedules K-1.

[6] The GMF system controls, validates, and corrects data from a variety of input sources (*e.g.*, tax returns, remittances, information returns, and adjustments).

[7] MeF is a web-based platform for filing approximately 330 forms to the IRS. It serves to streamline filing processes and reduce the costs associated with a paper-based process.

flow-through entity can attempt e-filing again. An example of a business rule for the TY 2016 Form 1120S is that Line I must indicate that one or more Schedules K-1 are attached. After acceptance, the data elements for e-filed Schedules K-1 matching the lines transcribed for paper forms are sent to the GMF. Although the MeF accepts prior year Schedules K-1 attached to flow-through returns, the data were not sent to the GMF until Processing Year 2018 to be consistent with paper processing.

The Information Returns Processing function receives paper and e-filed information returns, including Schedules K-1, from the GMF. Before adding records to the Information Returns Master File (IRMF), a payee Taxpayer Identification Number (TIN) verification is conducted with systemic attempts *************2***************.[8] Results of this TIN verification are stored with the records added to the IRMF. Compliance programs use the IRMF data to identify potential noncompliance. For example, the IRMF data are matched with tax account data to identify potential nonfilers and matched with tax return data to identify potential underreporters. However, *********************2*******************************
***********************2**********************

New technologies are frequently introduced that enhance how people conduct business and raise expectations of the services they should receive. However, the IRS is finding it increasingly difficult to meet taxpayer expectations and deliver upon its growing mission without extensive changes to its technology systems. The IRS legacy infrastructure cannot keep pace with the desire for instantaneous data, real-time interactions, and other customer services. In addition, the cost to operate the legacy systems is continuing to rise. On April 18, 2019, the IRS announced a six-year plan to modernize its information technology systems to help deliver quality service to taxpayers, provide efficient and robust enforcement activities, and keep taxpayer data secure. The IRS will implement this plan in two three-year phases starting in FY 2019, monitor its progress, and adjust investment decisions accordingly. The plan, which is dependent on future funding, is anticipated to cost between $2.3 billion and $2.7 billion.

In addition to improving taxpayer services and data security, the IRS's technology modernization plan has components to improve compliance efforts. Examples include the development of a consolidated enterprise-wide case management system to replace approximately 60 case management systems that will allow the IRS to resolve issues through improved management of case creation, execution, maintenance, and closure. The Return Review Program will integrate taxpayer data from multiple sources and provide systemic detection results for noncompliance. Information returns processing will have a modern intake database and applications that will improve document matching. Data digitization will simplify and streamline the integration of

[8] A TIN is a nine-digit number assigned to an entity (*e.g.*, business, flow-through, or individual) for tax identification purposes. Depending upon the nature of the entity, the TIN is an Employer Identification Number, a Social Security Number, or an Individual TIN.

scanned data to improve processing of paper submissions and create efficiencies from not having to manually process, transcribe, and store documents.

This review was performed at the IRS Wage and Investment Division's Submission Processing function in Ogden, Utah; the Small Business/Self-Employed Division's Automated Underreporter (AUR) program campus in Ogden, Utah; and the Small Business/Self-Employed Division's Business Underreporter (BUR) program campus in Ogden, Utah, and with information obtained from the Wage and Investment Division Headquarters in Atlanta, Georgia; the Small Business/Self-Employed Division Headquarters in Lanham, Maryland; and the Information Technology Headquarters in Lanham, Maryland, during the period August 2017 through July 2019. 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 effectiveness of the IRS's use of Schedule K-1 data to address noncompliance depends on adequate resources to operate a well-designed process supported by reliable information. A weakness in one area not only limits the IRS's effectiveness to address noncompliance but can also create weaknesses in the other areas. Our review of how the IRS uses Schedule K-1 data determined that improvements are needed with the process design and collection of data to strengthen efforts to address the noncompliance of nonfilers and underreporters.

The Internal Revenue Service Accepts Flow-Through Returns With *********************2*****************Schedules K-1

*************2*********** Schedules K-1 will limit the IRS's ability to identify potential noncompliance, resulting in the loss of tax revenue and inequitable treatment of taxpayers as well as potentially creating unnecessary work and increasing taxpayer burden. We determined that improvements in the receipt and storage of Schedule K-1 data will increase information reliability and availability, which will assist in identifying potential tax noncompliance.

Accurate and complete Schedule K-1 data are not always received

The number of Schedules K-1 received by the IRS continues to increase, but more importantly, an increasing percentage are e-filed. In Calendar Year (CY) 2010, the IRS received 33.5 million Schedules K-1 with Forms 1041, 1065, and 1120S, of which 14.5 million (43 percent) were in paper format. By CY 2017, 39.3 million Schedules K-1 were received, with only 3.5 million (9 percent) in paper format. The IRS estimates that, in CY 2025, 45.7 million Schedules K-1 will be received, with just 1.3 million (3 percent) in paper format. Figure 2 shows the number of Schedules K-1 received or expected to be received from CYs 2010 to 2025 with Forms 1041, 1065, and 1120S, along with the percentage in paper and e-file format.

Figure 2: Number of Schedules K-1 by Type and Format

CY	Form 1041 Schedule K-1 Number	Form 1041 Percent Paper	Form 1041 Percent E-File	Form 1065 Schedule K-1 Number	Form 1065 Percent Paper	Form 1065 Percent E-File	Form 1120S Schedule K-1 Number	Form 1120S Percent Paper	Form 1120S Percent E-File
Actual									
2010	3,305,715	74%	26%	23,054,696	34%	66%	7,095,363	59%	41%
2011	3,272,177	46%	54%	22,851,661	26%	74%	6,950,935	45%	55%
2012	3,447,437	36%	64%	25,466,066	18%	82%	7,162,330	33%	67%
2013	3,360,025	30%	70%	26,947,888	15%	85%	7,226,768	27%	73%
2014	3,573,432	27%	73%	28,470,646	12%	88%	7,231,007	22%	78%
2015	3,403,736	22%	78%	29,931,317	9%	91%	7,431,895	18%	82%
2016	3,208,206	21%	79%	29,169,826	8%	92%	7,556,377	15%	85%
2017	3,379,324	18%	82%	28,321,164	7%	93%	7,609,741	13%	87%
IRS Estimates									
2018	3,137,100	18%	82%	30,239,400	5%	95%	7,795,000	11%	89%
2019	3,101,400	17%	83%	30,774,100	5%	96%	7,935,800	10%	90%
2020	3,065,800	16%	84%	31,308,900	4%	96%	8,076,700	8%	92%
2021	3,030,100	15%	85%	31,843,600	3%	97%	8,217,500	7%	93%
2022	2,994,500	14%	86%	32,378,400	3%	97%	8,358,300	6%	94%
2023	2,958,800	13%	87%	32,913,100	3%	97%	8,499,100	5%	95%
2024	2,923,200	12%	88%	33,447,800	2%	98%	8,639,900	4%	96%
2025	2,887,500	11%	89%	33,982,600	2%	98%	8,780,800	4%	96%

Source: Publication 6961, Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses (revisions 07-2011 through 08-2018).

Fewer paper forms received means less data to convert to electronic format, which should increase data reliability due to fewer transcription errors as well as make the data available earlier for computer compliance checking systems. However, Schedules K-1 submitted in electronic format can also contain *********2******** information that can limit systemic checking of recipients for nonfiler and underreporter noncompliance. We analyzed e-filed flow-through returns and their Schedules K-1 for TYs 2015 and 2016 and determined that millions of forms had ***************2************ information.

Each flow-through return has a line item to indicate the number of recipients (benefactors, partners, or shareholders) to allocate shares of income, deductions, credits, and other amounts for the tax year *****************2***********************.[9] For example, *2* **************************************2************************************ **************************************2************************************ We **************************************2********************************* and found thousands of e-filed flow-through returns for TYs 2015 and 2016 that ******2****** **********************************2************************.[10] Figure 3 shows the number of potential **2*** e-filed Schedules K-1 by type of flow-through return. Although a significant number of flow-through entities had preparer assistance to file their returns,*2*

[9] The number of recipients is shown on Line B on page 1 of Form 1041, if making an income distribution deduction on Line 18; Line I on page 1 of Form 1065; and Line I on page 1 of Form 1120S.

[10] Subsequent amended returns were not submitted by these flow-through entities.

*****************************2*********************************** may be a return preparer error but also could be done intentionally to help recipients evade taxes.

Figure 3: Potential ****2**** E-Filed Schedules K-1

	TY 2015					TY 2016				
	Number of Flow-Through Returns	**Percent Involved Preparer**	*****2*** ****2**** ****2******	*****2*** ***2*** *2***	*****2*** ***2*** ***2*** *2***	**Number of Flow-Through Returns**	**Percent Involved Preparer**	*****2*** ***2*** ***2*****	*****2*** ***2*** *2***	*****2*** ***2*** ***2*** *2***
E-Filed Form 1041 With Income Distribution Deduction and Without Subsequent Amended Return										
2 ****2**** Schedules K-1	18	0.0%	37	19	18	26	23.1%	56	27	29
2 Schedules K-1 ***2***	Not displayed due to IRS data storage problem[11]					1,626	91.5%	1,354	0	2,497[12]
E-Filed Form 1065 Without Subsequent Amended Return										
2 ****2**** Schedules K-1	4,854	96.8%	39,168	29,497	9,671	4,496	98.2%	49,752	35,099	14,653
2 Schedules K-1 ***2***	5,530	96.9%	39,436	0	39,436	Not displayed due to IRS data storage problem[13]				
E-Filed Form 1120S Without Subsequent Amended Return										
2 *****2***** Schedules K-1	4,233	98.5%	37,485	6,739	30,746	2,460	98.3%	31,885	3,851	28,034
2 Schedules K-1 ***2***	228	99.6%	310	0	367[14]	45	91.1%	14	0	54[15]

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of e-filed flow-through data submitted to the MeF.

Historically, the IRS receives a large number of information returns with *******2********** *******2*******, although these represent a small percentage of the total number of information returns. If the IRS cannot verify or correct information returns to identify the payee, *************************2************************************* More information returns were received from TY 2013 to TY 2016, but fewer had *******2********

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[11] During data validation, we identified TY 2015 Forms 1041 with attached Schedules K-1, but no Schedule K-1 data were stored in the IRS source file for the Form 1041. The IRS confirmed the problem but did not know when or if it could be corrected. This does not affect other results displayed.

[12] Minimum ****2**** Schedules K-1 because an estate/trust must have at least one beneficiary when making an income distribution deduction but 1,143 *******2******** Schedules K-1 for beneficiaries on page 1 of Form 1041 and *2* Schedules K-1 ****2****. The other estates/trusts making an income distribution deduction *************2*************** Schedules K-1.

[13] During data validation, we identified TY 2016 Forms 1065 with attached Schedules K-1, but no Schedule K-1 data were stored in the IRS source file for the Forms 1065. The IRS confirmed the problem but did not know when or if it could be corrected. This does not affect other results displayed.

[14] Minimum ***2** Schedules K-1 because an S Corporation must have at least one shareholder but 57 ****2**** shareholders on page 1 of Form 1120S and *******2****** Schedules K-1. The other S Corporations ***2*** shareholders *****2***** Schedules K-1.

[15] Minimum **2** Schedules K-1 because an S Corporation must have at least one shareholder but 40 ****2**** shareholders on page 1 of Form 1120S and *******2******* Schedules K-1. The other S Corporations***2*** shareholders *****2***** Schedules K-1.

****2**** that could not be verified or corrected. The number of information returns received by the IRS was 2.3 billion in TY 2013 and increased to 3.6 billion in TY 2016. Of these, 46 million (1.9 percent) had *********2*********** that could not be verified or corrected in TY 2013, while 26 million (0.7 percent) had *********2*********** that could not be verified or corrected in TY 2016. However, the percentage of Form 1065 Schedules K-1 with ***********2********* that are not verified or corrected is significantly higher each tax year than for any other Schedule K-1 types as well as for all information returns. We also noted that most Schedules K-1 with **********2************ regardless of type, were electronically submitted to the IRS. Figure 4 shows the number of all information returns and the different Schedule K-1 types received for which the IRS was not able to verify or correct ***********2***********

Figure 4: Information Returns With *********2****** *****2***** That the IRS Is Unable to Verify or Correct**

Information Return Type	TAX YEAR			
	TY 2013	TY 2014	TY 2015	TY 2016
Number of All Information Returns	2,348,015,753	2,660,531,114	3,063,172,386	3,619,252,798
Number with *********2********* not verified or corrected	45,597,442	34,069,071	31,657,540	25,963,082
Percent with **********2********* not verified or corrected	1.94%	1.28%	1.03%	0.72%
Number submitted electronically with *********2*********** not verified or corrected	39,453,442	31,010,572	28,742,307	24,011,177
Number of Form 1041 Schedules K-1	3,730,341	3,405,988	3,208,206	3,367,444
Number with ********2*********** not verified or corrected	95,521	53,532	51,566	47,782
Percent with ********2*********** not verified or corrected	2.56%	1.57%	1.61%	1.42%
Number submitted electronically with ***********2********* not verified or corrected	49,086	28,556	28,742	28,838
Number of Form 1065 Schedules K-1	31,207,506	29,934,192	29,169,826	28,287,752
Number with **********2********* not verified or corrected	4,388,661	2,985,908	2,334,930	2,235,832
Percent with **********2********* not verified or corrected	14.06%	9.97%	8.00%	7.90%
Number submitted electronically with ************2******** not verified or corrected	4,162,797	2,876,910	2,243,787	2,163,945
Number of Form 1120S Schedules K-1	7,583,730	7,433,668	7,556,377	7,597,838
Number with *********2********** not verified or corrected	123,490	60,962	56,629	53,024
Percent with *********2********** not verified or corrected	1.63%	0.82%	0.75%	0.70%
Number submitted electronically with **********2********** not verified or corrected	70,860	38,997	37,995	37,016

Source: IRMF File Report 417-91-40 for TYs 2013, 2014, 2015, and 2016.

We analyzed e-filed Schedules K-1 submitted before the IRS conducted payee TIN/name verification and correction and found thousands of Schedules K-1 showing billions of dollars in income for TYs 2015 and 2016 with ***************2*****************.[16] Figure 5 summarizes our results for ******************2************** with the largest number being Form 1065 Schedules K-1 with ***2*** payee TINs. The forms identified as ***2*** payee TINs ******2****** but may have either *******************2*************** *****2****** The forms with *********2*********** include those having the ***2*** ****************************2*************************** despite the fact that a

[16] Subsequent amended returns were not submitted by these flow-through entities.

flow-through entity cannot allocate to self as recipient.[17] Other noticeable errors include ***************************************2************************************ ***************************************2************************* Although a significant number of flow-through entities filed their returns with preparer assistance, the ******************2****************** on Schedules K-1 could be a return preparer error (due to *************2*****************) but also could be done purposely to help recipients evade taxes.

Figure 5: ****************2******************Payee TINs**

Payee TIN on Schedule K-1	TY 2015 Number of Schedules K-1	TY 2015 Allocated Income on Schedules K-1[18]	TY 2015 Percent Preparer Involved	TY 2016 Number of Schedules K-1	TY 2016 Allocated Income on Schedules K-1	TY 2016 Percent Preparer Involved
Form 1041 Schedules K-1						
**********2***********	3,272	$26,279,363	98%	4,055	$152,234,345	98%
**********2***********	3,002	$37,760,521	95%	2,936	$24,018,244	95%
**********2***********	165	$596,905	71%	172	$705,040	81%
**********2***********	932	$1,211,840	96%	1,033	$7,879,478	96%
**********2***********	185	$2,603,283	99%	197	$7,785,044	97%
Subtotal	**7,556**	**$68,451,912**	**96%**	**8,393**	**$192,622,151**	**96%**
Form 1065 Schedules K-1						
**********2***********	401,424	$73,080,085,844	98%	347,791	$39,069,354,876	98%
**********2***********	12,802	$141,150,776	93%	20,660	$1,081,486,978	93%
**********2***********	2,391	$11,031,376	92%	1,469	$3,808,598	92%
**********2***********	11,127	$1,530,817,849	94%	11,809	$967,292,179	94%
**********2***********	785	$49,103,401	94%	707	$255,526,148	93%
Subtotal	**428,529**	**$74,812,189,246**	**97%**	**382,436**	**$41,377,468,779**	**97%**
Form 1120S Schedules K-1						
**********2***********	471	$14,101,479	96%	492	$4,787,832	95%
**********2***********	7,017	$550,428,734	97%	6,915	$673,908,935	97%
**********2***********	104	$9,327,885	93%	116	$5,691,396	91%
**********2***********	295	$182,106,220	87%	316	$198,197,615	88%
**********2***********	138	$3,175,463	94%	150	$2,281,271	95%
Subtotal	**8,025**	**$759,139,781**	**96%**	**7,989**	**$884,867,049**	**96%**
Forms 1041, 1065 and 1120S Schedules K-1						
**********2***********	405,167	$73,120,466,686	98%	352,338	$39,226,377,053	98%
**********2***********	22,821	$729,340,031	94%	30,511	$1,779,414,157	94%
**********2***********	2,660	$20,956,166	91%	1,757	$10,205,034	91%
**********2***********	12,354	$1,714,135,909	94%	13,158	$1,173,369,272	94%
**********2***********	1,108	$54,882,147	95%	1,054	$265,592,463	94%
Total	**444,110**	**$75,639,780,939**	**97%**	**398,818**	**$42,454,957,979**	**97%**

Source: TIGTA analysis of e-filed flow-through data submitted to MeF.

Flow-through entities compute income and other tax-related amounts for a tax year on their return and then allocate the amounts to recipients using the appropriate Schedule K-1. The sum of the allocated amounts on Schedule K-1 should equal the amounts shown on the flow-through

[17] We did not take exception if Form 1120S Schedule K-1 was for an Employee Stock Option Plan.

[18] Schedules K-1 contain multiple boxes to enter different income and deduction amounts that could be positive or negative. This column and the one used for TY 2016 combined the amounts from selected box amounts. For Form 1041 Schedules K-1, we used boxes 1, 2a, 3, 4a, 5, 6, 7, and 8. For Form 1065 Schedules K-1, we used boxes 1, 2, 3, 4, 5, 6a, 7, 8, 9a, and 12. For Form 1120S Schedules K-1, we used boxes 1, 2, 3, 4, 5a, 6, 7, 8a, & 11.

returns. For example, a partnership with three equal-share partners that earned a total of $600,000 of ordinary business income would report $600,000 on Form 1065 Schedule K, Line 1, and allocate $200,000 on each of the partners' Schedule K-1, Line 1.

We *****************2********** on e-filed flow-through returns for TYs 2015 and 2016 to ******************2***************** and found thousands of returns ***2*** **2**[19] Some had more than ********2********* and some may only be *******2******** ***2*** However, we still found thousands of returns with ********2********** of $10,000 or more. Figure 6 summarizes our results for flow-through entities with*******2**** *******************2****************************** Commonly *****2**** ***2*** for Form 1065 involved ****************2****************************** ****2***** Commonly *******2******** for Form 1120S involved ********2******** ***********2************* Although a significant number of flow-through entities filed their returns with preparer assistance, the ***************2************************ *****2***** could be a return preparation error but also could be done purposely to help recipients evade taxes.

Figure 6: ***************2******************
Flow-Through Returns and Attached Schedules K-1**

	Number of Flow-Through Entities With ****2**** ****2****	Percent Involved Preparer	Number of ****2**** ****2****	Number of ****2**** ****2**** of $10,000 or More
Form 1041 and Attached Schedules K-1[20]				
TY 2015	32,181	95.5%	32,181	2,305
TY 2016	27,293	94.0%	27,293	2,015
Form 1065 and Attached Schedules K-1				
TY 2015	220,484	93.1%	263,535	117,262
TY 2016	203,340	93.0%	241,121	105,931
Form 1120S and Attached Schedules K-1				
TY 2015	162,718	99.1%	174,701	130,702
TY 2016	171,262	99.3%	182,881	139,373

Source: *TIGTA analysis of e-filed flow-through data submitted to MeF.*

MeF processing can use its business rules to reject incomplete e-filed flow-through returns. These business rules are available to the public, which could allow tax return preparation

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[19] Subsequent amended returns were not submitted by these flow-through entities. In addition, we only considered flow-through entities that **************************2** **********2***********

[20] We were not able to determine ****************2***************** Instead, we ******2******** ***2**********************************

software companies to establish validation checks to prevent errors before information is submitted to the IRS. However, there is no MeF business rule to reject the return when:

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

When asked about establishing business rules, IRS officials said rejection rules for MeF processing should be consistent with how paper submission processing determines when to reject paper returns, although they also agreed that MeF already has some business rules that are inconsistent with paper submission processing. For example, IRS officials said paper submission processing will *********************2******************************* ***2*** which is not consistent with MeF processing. However, paper submission processing is consistent with MeF processing in that both do not check if:

- **************2***************
- **************2****************
- **************2*****************

Although payees on information returns, including Schedules K-1, are checked for TIN/name validity after submission processing and some are corrected before being added to the IRMF, we are not aware of checks for the other items discussed above. In addition, we do not know of any IRS outreach to flow-through entities, return preparers, tax practitioners, or tax preparation software companies to improve the reliability of Schedule K-1 data submitted to the IRS.

Flow-through entities should provide *******2******* Schedules K-1 that include ****2**** *****************2****************** Regardless of whether the returns are submitted electronically or on paper, the IRS should ensure that required information is provided and is reliable by conducting validity checks as soon as possible to prevent unreliable data from entering its systems. Otherwise, the IRS's ability to identify potential nonfiler and underreporter noncompliance by flow-through recipients is limited, resulting in loss of tax revenue and inequitable taxpayer treatment.

Penalties for ********2************ Schedules K-1 are not applied consistently***

If Schedules K-1 *******************2***************** the Internal Revenue Code provides authority for the IRS to apply a penalty to the flow-through entity submitting the form.[21]

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[21] Internal Revenue Code Section (§) 6698 for partnerships, § 6699 for S Corporations, and § 6723 for estates/trusts, which apply when a Schedule K-1 is not provided or a Schedule K-1 does not include accurate information (this includes ***********2************ but not ******2******* on Schedules K-1). Penalties can be abated for reasonable cause.

Penalties exist to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue Code. Penalties also support the public conviction that the tax system is fair by assuring compliant taxpayers that tax offenders are identified and penalized in proportion to the severity of the noncompliance. To preserve and enhance voluntary compliance, the IRS must administer a system of penalties that is fair, consistent, and accurate. However, we found that penalty application is inconsistent for **********2********* Schedules K-1.

The chances of receiving a penalty for submitting a Schedule K-1 with *********2**********
2 depends on how the flow-through return was submitted to the IRS and the type of flow-through entity. IRS paper submission processing has a process to assess penalties on partnerships and S Corporations with ********2********* Schedules K-1 after attempting to resolve the issue by correspondence. However, the IRS has *************2**************
******************2********************** IRS e-file submission processing **2*
*************************************2**************************************
******2****** After paper or e-file submission processing is complete, Examination may consider assessing a penalty if it discovers *********2******** Schedules K-1 during the course of a case review. IRS officials said they analyze the application of some penalties, but the Schedule K-1 penalty is not commonly evaluated.

We determined that Schedule K-1 penalties were assessed on 5,807 partnerships, 5,176 S Corporations, and no estates/trusts with tax periods ending in CY 2015 or 2016. Of those entities assessed Schedule K-1 penalties, only 24 were e-filed partnerships and three were e-filed S Corporations. Considering that substantially more Schedules K-1 are e-filed than submitted by paper, and the previously discussed finding that thousands of e-filed Schedules K-1 had ********2******** Schedules K-1, we conclude that the application of penalties by the IRS is inconsistent for *******2********* Schedules K-1. This inconsistency is inequitable to those required to submit Schedules K-1 and may affect the public's perception that the tax system is fair.

Electronic storage of Schedule K-1 data is limited

As previously mentioned, Schedules K-1 submitted by paper are scanned, but only certain lines, called transcribed lines, are recorded and stored on the IRMF for future compliance activity. Although all e-filed Schedule K-1 data are received in electronic format, only the transcribed lines are electronically stored in the IRMF. For example, the IRMF does not store data for all income, deduction, and credit amounts for Form 1065, Schedule K-1, regardless of whether submitted by paper or electronically.[22] In addition, not all partner information is stored for the Form 1065, Schedule K-1.[23] Therefore, the IRS's *************2*****************

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[22] Examples include **************************2***
2*************************************

[23] Examples include **************************2**
*******2********.

**************************************2***********************************
**************************************2********************* In addition, the lack of data limits IRS employees' use of the IRMF for specific case research, such as during an examination. Considering that a large majority of Schedules K-1 are e-filed, and the trend is that more will be e-filed in future years, the IRS should expand the amount of electronic Schedule K-1 data stored in the IRMF or develop a process to use e-filed Schedule K-1 data while waiting to determine if more paper Schedule K-1 data can be transcribed.

IRS officials said transcription needs are evaluated each year to determine if more can be done. However, the officials also stated that any changes to the data fields transcribed for Schedule K-1 and stored in the IRMF for future noncompliance identification must be consistent between paper and e-filed submissions because using data from one return source differently than another may lead to different treatment between taxpayers, which could discourage e-filing. The IRS has publicly stated that e-filing will not increase or decrease the chances of being audited. However, the IRS has also acknowledged the distinction between using the data from different sources to identify returns for audit, compared to having the data available for possible later use during an audit.

Recommendations

Recommendation 1***:*** The Commissioner, Wage and Investment Division, should conduct periodic outreach to encourage submission of reliable Schedule K-1 data to the IRS. Topics should include **************************2********************************
**************************************2********************************
**************************************2**************** The outreach should be directed to those involved with preparing and submitting Schedule K-1 data to the IRS (*e.g.*, flow-through entities, return preparers, tax practitioners, and tax preparation software companies).

> ***Management's Response:*** The IRS agreed with this recommendation and will perform outreach to affected stakeholders, including tax preparation software companies. It will also develop a communication action plan to support periodic outreach directed to flow-through entities, return preparers, and tax practitioners to encourage submission of reliable Schedule K-1 data to the IRS.

Recommendation 2: The Commissioner, Wage and Investment Division, should conduct a review to determine the process changes needed to increase the consistency of Schedule K-1 penalty application, especially for *********2********* e-filed Schedules K-1.

Management's Response: The IRS agreed with this recommendation and will perform a review to identify where procedural changes may be made to improve the consistency of penalty application for ******2********* filings of the Schedule K-1 family of information returns.

Recommendation 3*:* The Commissioner, Small Business/Self-Employed Division, should establish a process to use more e-filed Schedule K-1 data for noncompliance identification and determine the feasibility of transcribing more data from paper Schedules K-1.

Management's Response: The IRS agreed with this recommendation and will initiate a compliance project using data from e-filed Schedules K-1. It will use the results of that compliance initiative to write a business justification for additional transcription, if appropriate.

The Internal Revenue Service Does Not Always Identify Nonfilers Who Receive Schedule K-1 Income

The Case Creation Nonfiler Identification Process (CCNIP) identifies potential individuals who are delinquent in filing their Form 1040, *U.S. Individual Income Tax Return* (*i.e.*, nonfilers). The CCNIP uses tax account and IRMF data to determine if an individual meets nonfiler criteria for a specific tax year. Once identified, potential nonfilers are categorized and prioritized using the types and amounts of income reported by third parties on information returns, which includes Schedules K-1.

Due to IRS resource constraints, not all identified nonfilers are pursued. Selection criteria are applied based on IRS workload plans. If selected, nonfiler notices are sent to individuals over several weeks to allow time to print notices, answer calls and correspondence, and process any delinquent returns received. If an individual does not respond to a nonfiler notice, a nonfiler case is created that may be sent to one of several work streams (*e.g.*, Automated Substitute for Return, Automated Collection System, or Collection Field Function).

We compared individuals who received at least one Form 1041, 1065, or 1120S Schedule K-1 to the CCNIP inventory to determine how many were identified as potential nonfilers by the IRS. Figure 7 summarizes the potential individual nonfilers identified by the IRS who received Schedules K-1 for TYs 2015 and 2016.

Figure 7: Schedule K-1 Recipients Identified As Potential Individual Nonfilers

Grouping	Situation	TY 2015 Schedule K-1 Income > $0	TY 2015 Schedule K-1 Income > $25,000	TY 2016 Schedule K-1 Income > $0	TY 2016 Schedule K-1 Income > $25,000
Special Processing	Potential identity theft	18,362	7,896	16,432	6,300
Not Selected for Nonfiler Processing	No return filed	172,480	33,638	170,129	25,588
	Return filed	183,870	55,993	260,486	89,427
Nonfiler Notice Sent	Return filed before notice sent	1,559	519	2,938	1,143
	Return filed after notice sent	3,279	1,055	19,494	7,699
	Waiting on response to notice	499	152	2,792	1,061
	No response, nonfiler case created	3,427	1,116	48,473	16,444
Resolved Nonfiler Case	Secured return from taxpayer	3,444	1,196	5,353	2,293
	Created substitute for return	2,181	702	979	337
	Determined not liable for tax	651	105	1,345	286
	Unable to locate taxpayer	43	16	29	7
	Suspended case	271	68	1,222	462
	Referred case to Examination	774	228	7,227	3,225
TOTAL		**390,840**	**102,684**	**536,899**	**154,272**

Source: *TIGTA analysis of Schedules K-1, tax account, and CCNIP data.*

We also identified individuals who receive Schedules K-1 and are potential nonfilers but are unknown to the IRS. These individuals do not have a tax account for the tax period to record tax return filings or compliance activity, are not connected as a spouse to another individual who filed or has compliance activity, and were not included in the CCNIP inventory for nonfiler consideration. Since a minimal amount of reported information return income may not require a tax return to be filed, we considered those with more than $25,000 of Schedule K-1 income to be potential individual nonfilers unknown to the IRS. Figure 8 summarizes the potential individual nonfilers not identified by the IRS who received Schedules K-1 for TYs 2015 and 2016.

Figure 8: Schedule K-1 Recipients Not Identified As Potential Individual Nonfilers

Individuals Who Received Schedules K-1	Form 1041 TY 2015	Form 1041 TY 2016	Form 1065 TY 2015	Form 1065 TY 2016	Form 1120S TY 2015	Form 1120S TY 2016
No tax account and not included in CCNIP as potential nonfilers	221,750	207,423	256,164	210,634	38,875	35,302
Deceased before tax year	10,189	5,822	91,994	41,833	7,541	4,269
Potential nonfilers not known to IRS with $25,000 or more of Schedule K-1 income	1,837	1,605	2,320	1,227	679	416
Deceased before tax year	419	148	1,934	929	530	298
Schedule K-1 income in millions for potential nonfilers not known to IRS with $25,000 or more of Schedule K-1 income	$134.7[24]	$127.9[25]	$273.8	$123.6	$74.8	$62.0
Deceased before tax year	$34.5	$10.3	$163.4	$70.4	$53.1	$24.1

Source: *TIGTA analysis of Schedules K-1, tax accounts, and CCNIP data.*

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24 **1**
**************1****************

25 **1**
**************1****************

IRS officials reviewed our results and said they found a computer programing issue that was preventing the identification of some potential individual nonfilers who received Schedules K-1. During assembly of information return data, three Schedule K-1 income types were not included in the analysis to identify potential nonfilers. This was corrected, and the revised programming was first used for TY 2018 nonfiler identification.[26] At the time of our discussion, IRS officials did not know if other computer programing issues were also preventing identification. Since all available Schedule K-1 income was not used to identify nonfilers, we believe this will also affect the categorizing, prioritizing, and selecting of the nonfiler inventory.

Figure 8 also includes additional details for a special situation involving individuals who are deceased before the tax year. These individuals did not have a tax account for a tax year in which Schedules K-1 were issued using their Social Security Numbers, but they had a date of death before the tax year. For many, the date of death was several years before the tax year, with some going back decades. The executors for these individuals are not required to file an individual income tax return for the tax year but may be required to file an estate income tax return for income earned after the date of death. However, additional research found that some *********************2************************** We found Schedules K-1 with the ****************2********** and ****2**** but the ****2**** on the Schedule K-1 ************************************2************************************** **2** This brings into question the actual recipient of the Schedule K-1 and complicates the IRS's ability to check tax compliance.

When the IRS checks information returns, including Schedules K-1, for *****2*** between the *****************2*********************** is used for verification, and ******2****** *******2******* Not considering ***********2*********** or ****2**** during information return ***2*** verification could give false positives for some individuals as a recipient of a Schedule K-1. We acknowledge that this ***2*** confusion starts with information return payers, specifically with the flow-through entities preparing the Schedules K-1. However, we did not find any information in Schedule K-1 instructions to explain how a flow-through entity should address reporting for a deceased recipient or what steps a flow-through entity could take to ensure that accurate recipient information is entered on Schedules K-1 when ownership in the flow-through entity changes from a deceased recipient.

Recommendations

The Commissioner, Small Business/Self-Employed Division, should:

Recommendation 4***:*** Enhance the information return ***2*** verification process to *******2******** in order to ensure that individuals are properly identified as payees.

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[26] The income types missing from nonfiler analysis included **************2************************** ***************2***************

Management's Response: The IRS disagreed with this recommendation, stating that the recommendation will provide minimal benefit to compliance enforcement activities and would require significant programming changes to accomplish. It also stated that the percentage of information returns received by a decedent is very small compared to the entire population of information returns received.

Office of Audit Comment: TIGTA contends that implementation of this recommendation would improve the IRS's ability to check tax compliance by better identifying the actual recipients of Schedules K-1.

Recommendation 5: Update flow-through form instructions to explain how a flow-through entity should address reporting a deceased recipient and the steps a flow-through entity could take to ensure that accurate recipient information is entered on Schedules K-1 when ownership changes from a deceased recipient.

Management's Response: The IRS agreed with this recommendation and will update its instructions to provide clearer direction to entities on how to properly issue a Schedule K-1 when the recipient is deceased.

Identification of Underreporter Noncompliance Could Be Improved

Although IRS employees conducting audits of tax returns have access to information return data and can address discrepancies with amounts reported, most discrepancies between information returns and tax returns are addressed by two IRS underreporter programs, the AUR and BUR. The AUR addresses information return discrepancies with individual income tax returns (*i.e.*, Form 1040 filers) and BUR addresses information return discrepancies with corporation and estates/trusts income tax returns (*i.e.*, Form 1120 and Form 1041 filers). The AUR began as an individual underreporter program in the 1970s and became known as the AUR when an automated case management system was created in the 1990s. The AUR program is currently conducted at seven locations. By comparison, BUR is a recent program that started with identifying TY 2012 Form 1120 underreporters and later expanded to identify TY 2015 Form 1041 underreporters. It is conducted at only one location and does not have an automated case management system.

The general underreporter process is similar for the AUR and BUR. Discrepancies are identified by computer matching and evaluated by a data analysis, called a correlation, up to three times for a given tax year. Correlations are conducted at different times to allow for consideration of tax return and information return data that could be received at different times (by original due date, extension due date, or after due date) and any amended data received. Underreporter cases are categorized and prioritized based on type of discrepancy. Cases not selected in an earlier correlation may be reconsidered in a later correlation. Cases are marked as "nonselect" when they contain items that have been historically nonproductive. Selection criteria are applied based on workload plans and, due to resource constraints, not all underreporter discrepancies are pursued.

If selected, examiners screen cases to determine whether the discrepancies can be resolved without contacting taxpayers or should be transferred to another compliance function. When discrepancies cannot be resolved, notices are sent to taxpayers explaining the discrepancies and proposing an additional assessment of taxes, interest, and penalties. Taxpayers can respond to notices by agreeing to the additional assessment or by providing explanations or documentation for examiners to consider for the discrepancies. After reviewing taxpayer responses, examiners may:

- Send revised underreporter notices to taxpayers when responses resolve part of the discrepancies.
- Send a notice of deficiency with appeal rights to taxpayers when responses do not resolve discrepancies.
- Close cases with an agreed assessment or no-change to tax.

Taxpayers that do not reply to underreporter notices are sent a notice of deficiency with appeal rights. A notice of deficiency can still result in a no-change to tax liability if taxpayers later provide explanations or documentation; otherwise, cases are closed with assessments or suspended if taxpayers appeal the assessments.

Underreporter identification does not ************2************************

The AUR and BUR only consider potential underreporting for those taxpayers that submit *********2********. Neither program identifies potential underreporting ******2******** *********2******** regardless of the type or amount of potential discrepancy, including those involving Schedule K-1 data. Figure 9 summarizes the number of individuals, corporations, and estates/trusts that submitted ***********2*********** Forms 1040, 1120, and 1041 for TYs 2013 through 2016. ********************2********************************* ***2********************************* ***************2****************.

Figure 9: ************2************ Forms 1040, 1120, and 1041 Submitted for TYs 2013 Through 2016**

	Form 1040		Form 1120		Form 1041	
	Number	Percent	Number	Percent	Number	Percent
TY 2013						
Total	148,393,541		1,814,151		3,195,415	
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
TY 2014						
Total	150,058,756		1,787,903		3,168,268	
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
TY 2015						
Total	151,222,313		1,737,952		3,157,053	
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
TY 2016						
Total	151,101,732		1,688,833		3,082,418	
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
Average	*150,194,086*		*1,757,210*		*3,150,789*	
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***
****2****	*****2****	***2***	*****2****	***2***	*****2****	***2***

Source: TIGTA analysis of return transaction data.

IRS officials said any *************************2******************************
*************************2*************************************. They would need the amounts **************************2**********************************
2 Right now, the only information return that has **************2***************
**********************2******************************* The IRS would also need to consider *********************************2*******************************
2****************************
2 In addition, it would be difficult to justify the cost to create a special ******2*****
****************************2******************************

We recognize that adding amounts *******2******* to information returns would be burdensome, costly, and complex for payers, payees/taxpayers, and the IRS. However, we believe that **********************2*************************** a potential noncompliance area that results in loss of tax revenue and inequitable taxpayer treatment and may diminish the public’s perception that the tax system is fair. The IRS should look for ways to overcome the barriers so that ****2**** taxpayers can be systemically checked for underreporting.

BUR does not review **************************2**********************************

As previously mentioned, BUR is a recent program that started identifying potential underreporting by corporations filing Forms 1120 and later expanded to identify potential underreporting by estates/trusts filing Forms 1041. However, because BUR *****2****** ***********************2***************************** it also does not identify noncompliance of the recipients of Schedule K-1. In addition, ************2************ could be a larger potential source of underreporting because these entities *******2******** ************************************2*********************************** ****2****. We believe that failing to consider ***********2************* for underreporting is overlooking a potential noncompliance area that results in loss of tax revenue, results in inequitable taxpayer treatment, and may diminish the public's perception that the tax system is fair.

Figure 10: Number of Returns Submitted

CY	Considered by BUR		Not Considered by BUR	
	Corporations Filing Form 1120	Estates/Trusts Filing Form 1041	*******2******* *******2*******	*******2******* *******2*******
2010	1,961,773	3,051,389	****2****	****2****
2011	1,927,509	3,036,900	****2****	****2****
2012	1,881,483	3,047,673	****2****	****2****
2013	1,842,717	3,178,797	****2****	****2****
2014	1,827,649	3,215,902	****2****	****2****
2015	1,794,158	3,174,929	****2****	****2****
2016	1,807,404	3,187,535	****2****	****2****
2017	1,725,595	3,115,763	****2****	****2****
IRS Estimates				
2018	1,694,700	3,106,500	****2****	****2****
2019	1,672,900	3,099,800	****2****	****2****
2020	1,654,400	3,095,200	****2****	****2****
2021	1,636,900	3,091,900	****2****	****2****
2022	1,619,700	3,089,600	****2****	****2****
2023	1,602,600	3,088,000	****2****	****2****
2024	1,585,500	3,086,800	****2****	****2****
2025	1,568,500	3,086,000	****2****	****2****

Source: Publication 6186, Calendar Year Projections for the United States and IRS Campuses (revisions 10-2011 through 11-2018).

IRS officials stated that they have considered **************2*********************** program but determined it was not feasible. IRS officials said that because BUR does not have an automated case management system, research must be performed manually, which makes ***********************************2************************************ ***********************************2************************************ The IRS also stated that this level of activity is not appropriate work for the grade level of BUR employees.

Instead, the IRS is conducting two Compliance Initiative Projects, one for ****2**** and one for *****2*****, to determine if a new Examination process can be developed to address underreporting by ************2************. BUR participated in the Compliance Initiative Projects by identifying potential underreporting discrepancies and referring the cases to Examination for review. The ****2**** Compliance Initiative Project started in June 2016, with results currently being evaluated. The *****2***** Compliance Initiative Project started in June 2019, with a completion expected by June 2021.

Fewer cases are selected for underreporter review due to declining resources

We reviewed AUR correlation data for TYs 2014, 2015, and 2016 and determined that approximately 3 percent of individuals identified as potential underreporters have a discrepancy with amounts reported from Schedules K-1. This percentage was also consistent for individuals whether or not selected for case review. However, the number of cases selected for review, including those with a Schedule K-1 discrepancy, decreased each year, with a significant decrease occurring in TY 2016. IRS officials said this was a continuation of a trend caused by declining resources to review cases, as shown by AUR staffing decreasing by 42 percent from FY 2011 to FY 2018. Figure 11 shows the number of individuals identified as potential underreporters by tax year, those with potential Schedule K-1 discrepancies, and those selected for case review.

Figure 11: Summary of AUR Discrepancies and Case Selection for TYs 2014, 2015, and 2016

AUR Case Selection Determination for Review	Potential Individual Underreporters	Individuals With a Schedule K-1 Discrepancy	Percent With a Schedule K-1 Discrepancy
TY 2014			
Not Selected	24,241,279	747,661	3.1%
Selected	3,978,193	126,861	3.2%
Total TY 2014	**28,219,472**	**874,522**	**3.1%**
TY 2015			
Not Selected	22,601,832	664,346	2.9%
Selected	3,862,506	134,753	3.5%
Total TY 2015	**26,464,338**	**799,099**	**3.0%**
TY 2016			
Not Selected	24,359,499	862,905	3.5%
Selected	3,327,619	82,432	2.5%
Total TY 2016	**27,687,118**	**945,337**	**3.4%**

Source: *TIGTA analysis of AUR correlation data for TYs 2014, 2015, and 2016.*

We also reviewed BUR correlation data and determined that approximately 3 percent of corporations identified as potential underreporters for TYs 2014 and 2015 had a discrepancy with the amounts reported from Schedules K-1. This percentage was also consistent for corporations whether or not selected for case review as well as similar to the percentage for individuals identified by the AUR. However, the percentage of estates/trusts with a discrepancy in amounts reported on Schedules K-1 is about twice the percentage of individuals and corporations. ************************2***********************************

****2*****. Figure 12 shows the number of corporations and estates/trusts identified as potential underreporters, those with a potential Schedule K-1 discrepancy, and those selected for case review.

Figure 12: Summary of BUR Discrepancies and Case Selection for TYs 2014, 2015, and 2016

BUR Case Selection Determination for Review	BUR Form 1120			BUR Form 1041		
	Potential Corporation Underreporters	Corporations With a Schedule K-1 Discrepancy	Percent With a Schedule K-1 Discrepancy	Potential Estate/Trust Underreporters	Estates/Trusts With a Schedule K-1 Discrepancy	Percent With a Schedule K-1 Discrepancy
TY 2014						
Not Selected	67,379	1,989	3.0%	Not Applicable		
Selected	34,577	1,046	3.0%	Not Applicable		
Total TY 2014	**101,956**	**3,035**	**3.0%**	**TY 2015 first year estates/trusts identified**		
TY 2015						
Not Selected	54,806	1,811	3.3%	247,268	17,353	7.0%
Selected	29,734	994	3.3%	***2***	***2***	***2***
Total TY 2015	**84,540**	**2,805**	**3.3%**	***2***	***2***	***2***
TY 2016 (only first of three correlations)[27]						
Not Selected	41,420	932	2.3%	189,529	7,768	4.1%
Selected	8,706	22	0.3%	***2***	***2***	***2***
Total TY 2016	**50,126**	**954**	**1.9%**	***2***	***2***	***2***

Source: TIGTA analysis of BUR correlation data for TYs 2014, 2015, and 2016.

Tracking closure reasons could be used to identify processing improvement areas

After cases are selected, the first step of the AUR and BUR case review is screening, in which examiners evaluate potential discrepancies and determine whether to close cases or to continue the review by contacting taxpayers to explain the discrepancies. Since this is the first step of the review, the screening closure rate can be high when starting review of a tax year until more cases are worked and closed in subsequent steps. An AUR or BUR no-change closure occurs if taxpayer contact resolves the discrepancies. To efficiently use its limited resources and minimize taxpayer burden, the IRS should attempt to select cases with a high probability of actual underreporting. A high screening or no-change closure rate is an indication that changes may be needed in taxpayer reporting, discrepancy identification, or case selection.

As shown in Figure 13, we reviewed AUR case review data for TYs 2014, 2015, and 2016 and determined that cases with a Schedule K-1 discrepancy had a screening closure rate about 25 percent higher than the overall rate for all cases. The no-change closure rate was similar between types of cases. Similarly, our comparison of BUR Form 1120 case review data for TYs 2014, 2015, and 2016 shows that the BUR Form 1120 screening closure rate is about 15 percent higher for cases with a Schedule K-1 discrepancy, as shown in Figure 14. In addition, the BUR no-change rate is much higher than the AUR no-change rate regardless of whether the case had a

[27] Other BUR correlations for TY 2016 had not been conducted when we requested data for our analysis.

Schedule K-1 discrepancy. Since **************2*******************************
***************************************2********************************
2.

Figure 13: Summary of AUR Screening and No-Change Closure Rates for TYs 2014, 2015, and 2016

AUR Case Review	All Cases			Cases With K-1 Discrepancy		
	TY 2014	TY 2015	TY 2016	TY 2014	TY 2015	TY 2016
Total Cases	3,899,574	3,903,422	3,398,418	126,453	134,924	80,188
Closed Cases	3,748,656	3,656,865	659,749	122,320	126,735	6,251
Percent Closed	96.1%	93.7%	19.4%	96.7%	93.9%	7.8%
Screening Closure Rate	16.3%	18.9%	40.7%	41.1%	47.8%	67.5%
No-Change Closure Rate	12.6%	14.2%	17.4%	15.1%	14.1%	9.0%

Source: TIGTA analysis of AUR case review data for TYs 2014, 2015, and 2016 as of June 2018.

Figure 14: Summary of BUR Form 1120 Screening and No-Change Closure Rates for TYs 2014, 2015, and 2016

BUR Form 1120 Case Review	All Cases			Cases With K-1 Discrepancy		
	TY 2014	TY 2015	TY 2016*	TY 2014	TY 2015	TY 2016*
Total Cases	34,577	29,734	8,706	1,046	994	22
Closed Cases	34,294	26,901	1,085	1,043	884	5
Percent Closed	99.2%	90.5%	12.5%	99.7%	88.9%	22.7%
Screening Closure Rate	22.3%	24.3%	51.9%	35.4%	46.6%	60.0%
No-Change Closure Rate	41.6%	42.8%	40.6%	38.7%	39.5%	0.0%

* These are not all the cases for TY 2016 because BUR Form 1120 completed the first of three correlations to select cases for review when we requested data for our analysis.

Source: TIGTA analysis of BUR Form 1120 case review data for TYs 2014, 2015, and 2016 as of March 2018.

IRS officials said they continually analyze case review closures looking for characteristics to improve future case selection. Although notes can be added to case files, procedures do not require examiners to explain the resolution for all cases, including common reasons for screening and no-change closures. For recurring situations, BUR examiners have the additional option of adding a code to a case that represents the reason for a no-change closure (*e.g.*, taxpayer reported amount *****************************2******************************** but this coding is not done for screening closures. The AUR has coding for general reasons (*e.g.*, discrepancy accounted for) but does not have coding for specific common reasons that screened or no-changed cases were closed *********************2**********************

We identified 69,411 TY 2015 AUR cases with a Schedule K-1 discrepancy that were closed without a tax change during screening or after taxpayer contact. We reviewed a random stratified sample of 151 cases to determine the reason Schedule K-1 discrepancies were resolved. Initially, we could not determine the resolutions of 30 sample cases, but AUR management reviewed the cases and provided us with the resolutions. Below are common reasons our sample AUR cases with a Schedule K-1 discrepancy resulted in a screening or no-change closure. We believe that tracking the reasons for screening and no-change closures would benefit the AUR by identifying problems that, if addressed by outreach or process improvements, would allow resources to be used for more productive underreporter cases as well as decrease taxpayer burden from unnecessary contact.

- 34 sample cases were closed due to ***********2*************************** *********2*********** The AUR has a procedure to close cases with a Schedule K-1 discrepancy if ***************************2***************************** *****2****requires advanced tax law training beyond the scope of AUR tax examiners. We estimate this closure reason involved 18,522 TY 2015 AUR cases.[28]

- 19 sample cases were closed with ******************2*********************** **2** none of which were marked as amended, **************2**************** ****2*** which caused a discrepancy with tax return data. The AUR has a procedure to resolve the discrepancy, including determining which Schedule K-1 is an amendment and disregarding the others or contacting the taxpayer to resolve the discrepancy. There are two reasons why Schedules K-1 are not marked amended. First, *******2******** are not marking Schedules K-1 as amended when attaching them to an amended flow-through return. Although not currently being done, IRS officials said they have the legal authority to record a Schedule K-1 as amended when submitted with an ****2**** ******2****** regardless of whether the Schedule K-1 itself is marked as amended. The other reason that Schedules K-1 are not marked as amended is due to an IRS computer problem that ***************2****************************. IRS officials are aware of the computer problem but said that they will not be able to correct data previously processed when the problem is fixed. We estimate this closure reason involved 8,772 TY 2015 AUR cases.[29]

- 18 sample cases were closed with ******2****** Schedule K-1 amounts, and the remaining ***************2*****************. The AUR has a procedure to close cases by applying a tolerance when evaluating Schedule K-1 discrepancies. IRS officials said the procedure was established around CY 1995 due to complaints about how Schedule K-1 discrepancies were reviewed. At that time, it was decided to limit the review of Schedule K-1 discrepancies by applying a tolerance. After discussing this procedure with IRS officials, they evaluated the procedure and stated that the IRS is planning to remove the procedure starting with TY 2018 cases. We estimate this closure reason involved 9,478 TY 2015 AUR cases.[30]

- 13 sample cases were closed because Schedule K-1 amounts were *******2******** on tax returns. Discrepancies can occur when Schedule K-1 amounts that should be

[28] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 13,143 and 23,900.
[29] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 4,747 and 12,798.
[30] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 5,358 and 13,597.

*******************************2*********************************** After receiving and verifying a taxpayer's response to an underreporter notice that the discrepancy was caused ****2**** the AUR sends a closing letter with a special paragraph to educate the taxpayer about ****2**** on future tax returns. Although this could prevent repeat discrepancies by the same taxpayer, the IRS does not conduct outreach to educate taxpayers and the practitioner community ****2**** or any other reason for underreporter discrepancies. We estimate this closure reason involved 6,137 TY 2015 AUR cases.[31]

- 7 sample cases were closed with *************2*************************** *****************2********************** The AUR has a procedure to close cases when Schedules K-1 ****************2******************* but a computer problem incorrectly identified cases for underreporter review. ****2**** ******************************2************************************ ********2********* This check box is a transcribed item that is stored on the IRMF for compliance checking. However, we found no **********2******** on the IRMF with ******2******* check box checked for TYs 2015 and 2016. The IRMF did not start showing the box as checked for TY 2017 until November 2018. Our analysis of the IRMF determined that the *****2***** box was not checked but should have been for:

  - 1,858,160 of 29,169,826 (6.4 percent) TY 2015 ****2**** Schedules K-1.
  - 1,614,993 of 28,310,964 (5.7 percent) TY 2016 ****2**** Schedules K-1.
  - 1,353,025 of 27,989,985 (4.8 percent) TY 2017 ****2**** Schedules K-1.

  IRS officials stated that, due to a computer problem, ********2******** was not recorded as checked, but the problem had been corrected starting with TY 2017 Schedules K-1. The officials did not know how long the computer problem had been present. We estimate this closure reason involved 3,447 TY 2015 AUR cases.[32]

We also identified 764 TY 2015 BUR ****2**** cases with a Schedule K-1 discrepancy that were closed without a tax change during screening or after taxpayer contact. We reviewed a random stratified sample of 154 cases to determine the reason Schedule K-1 discrepancies were resolved. Since BUR does not have an automated case management system, we could not determine the resolution for 64 sample cases due to limited or no information in the case files. Below are common reasons that the sample BUR cases with a Schedule K-1 discrepancy resulted in a screening or no-change closure. The BUR does have a means to track common reasons that cases are closed as a no-change after taxpayer contact but does not track screen-out closures. We believe that tracking trends for screen-out closures would benefit BUR by identifying problems

[31] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 2,722 and 9,552.
[32] The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the point estimate is between 817 and 6,078.

that, if addressed by outreach or process improvements, would allow resources to be used for more productive underreporter cases.

- 16 sample cases were closed for taxpayers *********2********. BUR has a procedure to suspend working cases ***************2**********************
2 However, during our sample review time period, BUR management decided to close cases for taxpayers ******************2*********************
******2****** We disagree with this decision because it did not distinguish between taxpayers ******************************2****************************
**************************************2***************************
*********2********* The decision also created inequitable treatment for taxpayers involved ********************2************************ The closing of cases should have followed the BUR procedure of considering the *******2********
2to each taxpayer.
- 41 sample cases were closed due to a ******2****** discrepancy that resulted in no tax change after resolution, such as *******************2**********************
****2**** In some cases, amended tax returns were received that agreed with the underreported amounts, but carrybacks or additional deductions were claimed that resulted in no tax change. As previously noted, the IRS does not conduct outreach to educate taxpayers and the practitioner community to prevent such underreporter discrepancies.
- 21 sample cases were closed due to ****2**** Schedule K-1 data. This includes
********************************2*********************************.
As previously noted, the IRS does not conduct outreach to educate flow-through entities and the practitioner community to prevent such underreporter discrepancies.

Recommendations

Recommendation 6***:*** The Commissioner, Small Business/Self-Employed Division, should conduct periodic outreach to reinforce how Schedule K-1 amounts should be reported on tax returns to prevent underreporter discrepancies. Topics should include when to report Schedule K-1 amounts received from flow-through entities **********2************
******2****** to report Schedule K-1 amounts on tax returns, and ****2**** Schedule K-1 amounts causes potential underreporter discrepancies that may require contact from the IRS to resolve. The outreach should be directed to those involved with preparing and submitting tax returns to the IRS (*e.g.*, taxpayers/flow-through recipients, return preparers, tax practitioners, and tax preparation software companies).

Management's Response: The IRS agreed with this recommendation and will develop and implement a communication action plan to support periodic outreach for each audience that will reinforce how Schedule K-1 amounts should be reported on tax returns to prevent underreporter discrepancies.

Recommendation 7: The Commissioner, Small Business/Self-Employed Division, should add the development of a BUR automated case management system to the Integrated Modernization Business Plan.

> ***Management's Response:*** The IRS agreed with this recommendation and stated that the BUR automated case management system is included as part of its Enterprise Case Management System, which is on the Integrated Modernization Business Plan.

Recommendation 8: The Commissioner, Wage and Investment Division, should ensure that the computer problem that caused amended Schedules K-1 not to be marked as amended on the IRMF has been corrected.

> ***Management's Response:*** The IRS agreed with this recommendation and will request programming changes to validate that indicators on the Schedule K-1 family of information returns are accurately recorded when the documents post to the IRMF. The IRS anticipates completing the programming by January 2021, subject to resource constraints and competing priorities.

Recommendation 9: The Commissioner, Wage and Investment Division, should establish a process to record Schedules K-1 as amended when submitted with an amended flow-through return regardless of whether the Schedule K-1 itself is marked as amended.

> ***Management's Response:*** The IRS agreed with this recommendation and will determine if it has the legal authority to automatically correct the indicators on the Schedule K-1 family of returns when they do not agree with the type of return with which they are being filed. If legal authority exists, the IRS will submit a request for programming to validate the consistency of the indicators with the parent return and apply the appropriate corrections to the documents. This programming would be subject to constrained Information Technology resources and competing priorities.

Recommendation 10: The Commissioner, Small Business/Self-Employed Division, should establish a process to track the reasons and trends in AUR closures to identify opportunities to conduct outreach, improve case selection, and update procedures to decrease closures that do not result in tax assessments.

> ***Management's Response:*** The IRS agreed with this recommendation and stated that it annually completes closed case reviews to identify opportunities to improve case selection. It also regularly participates in practitioner meetings, tax forums, and other meetings (*e.g.*, Tax Talk Today) to discuss the AUR program. The IRS also stated that it had revised its policies in 2017 and 2018 to update guidance when appropriate to reduce no-change cases.

Office of Audit Comment: TIGTA found instances in which action was needed to decrease AUR closures that do not result in tax assessments and believes there is insufficient coding to identify common reasons that could be used to focus research to identify problems that may require action.

Recommendation 11***:*** The Commissioner, Small Business/Self-Employed Division, should establish a process to track the reasons and trends in BUR screen-out closures to identify opportunities to conduct outreach, improve case selection, and update procedures to decrease screening closures that do not result in tax assessments.

Management's Response: The IRS agreed with this recommendation and stated that it annually completes closed case reviews to identify opportunities to improve case selection. The IRS stated that its annual reviews are effective and have reduced screen-outs by 37.3 percent. It also stated that outreach is conducted on a case-by-case basis given the low number of cases included in the program.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS uses Schedule K-1 data effectively to identify taxpayers not submitting tax returns or taxpayers underreporting tax while also minimizing unnecessary notices to taxpayers. To accomplish this objective, we:

I. Discussed with IRS employees how Schedules K-1 are received, evaluated, and used for the nonfiler and underreporter programs.

II. Determined whether the IRS uses Schedule K-1 data effectively to identify taxpayers not submitting tax returns.

A. Compared TY 2015 Form 1041 Schedule K-1 data with current Individual Master File and Business Master File data to identify beneficiaries *********2*********** ***********2************ and to determine if the IRS had identified the potential nonfilers.

B. Compared TY 2015 Form 1065 Schedule K-1 data with current Individual Master File and Business Master File data to identify partners ************2************ **********2************ and to determine if the IRS had identified the potential nonfilers.

C. Compared TY 2015 Form 1120S Schedule K-1 data with current Individual Master File and Business Master File data to identify shareholders **********2********** ************2*********** and to determine if the IRS had identified the potential nonfilers.

D. Discussed with IRS employees the results from our nonfiler testing.

III. Determined whether the IRS uses Schedule K-1 data effectively to identify taxpayers underreporting tax while minimizing unnecessary notices to taxpayers in the AUR program.

A. Obtained and validated a TY 2015 AUR extract that was used to identify cases with an indication of a Schedule K-1 ***2*** and how cases were resolved.

B. Reviewed a random stratified sample of 151 of 69,411 TY 2015 AUR cases with an indication of a Schedule K-1 ***2*** that were closed without an assessment (screen-outs and no-change cases) to identify common reasons for unproductive cases that could be prevented in the future. Stratification was based on closing process code. We confirmed the sampling methodology with our contracted statistician.

C. Discussed with IRS employees the results from our AUR case testing.

IV. Determined whether the IRS uses Schedule K-1 data effectively to identify taxpayers underreporting tax and minimize unnecessary notices to taxpayers in the BUR program.

A. Obtained and validated a TY 2015 BUR Form 1120 extract that was used to identify cases with an indication of a Schedule K-1 ***2*** and how cases were resolved.

B. Reviewed a random stratified sample of 154 of 764 TY 2015 BUR Form 1120 cases with an indication of a Schedule K-1 ****2**** that were closed without an assessment (screen-outs and no-change cases) to identify common reasons for unproductive cases that could be prevented in the future. Stratification was based on closing process code. We confirmed the sampling methodology with our contracted statistician.

C. Obtained and validated a TY 2015 BUR Form 1041 extract that was used to identify cases with an indication of a Schedule K-1 ***2**** and how cases were resolved.

D. Discussed with IRS employees the results from our BUR Form 1120 and Form 1041 case testing as well as the feasibility of increasing the variety of BUR cases.

V. Discussed with IRS employees the feasibility of improving the reliability of Schedule K-1 data for the nonfiler and underreporter programs.

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: the Small Business/ Self-Employed Division's policies, procedures, and practices for using Schedule K-1 data to identify taxpayers not submitting tax returns or taxpayers underreporting tax. We evaluated these controls by reviewing policies and procedures as well as reviewing samples of AUR and BUR cases.

Appendix II

Major Contributors to This Report

Mathew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Glen Rhoades, Director
Robert Jenness, Audit Manager
Aaron Foote, Lead Auditor
Sean Morgan, Senior Auditor
Laura Haws, Information Technology Specialist

Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Deputy Commissioner for Operations Support
Commissioner, Small Business/Self-Employed Division
Commissioner, Wage and Investment Division
Chief Information Officer
Director, Collection, Small Business/Self-Employed Division
Director, Examination, Small Business/Self-Employed Division
Director, Operations Support, Small Business/Self-Employed Division
Director, Customer Account Services, Wage and Investment Division
Director, Customer Assistance, Relationships and Education, Wage and Investment Division
Director, Operations Support, Wage and Investment Division
Director, Enterprise Audit Management

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

September 9, 2019

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Eric C. Hylton Eric C. Hylton
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – 201730020 – The Use of Schedule K-1 Data to Address Taxpayer Noncompliance Can Be Improved

Thank you for the opportunity to review and comment on the above subject draft audit report. There are over 50 types of information reporting forms, including Schedule K-1, which is used by flow-through entities to report the recipient's allocated share of income, deductions, credits, and other amounts. We received over 39.3 million Schedules K-1 in 2017 and project we will receive over 45.6 million in 2025. The scope of this audit, as noted in your report, was on the proper filing and utilization of Schedule K-1 data.

We have two programs that address reporting discrepancies for individuals, corporations, and estates/trusts. These programs also identify the discrepancies for partnerships and S-Corporations and provide leads to other functions because of the complexity of the examination work associated with partnerships and S-Corporations.

We are dedicated to using all information we have available to support enforcement activities and will initiate a compliance project to determine if there is a business justification for using additional Form Schedule K-1 information in our compliance activities. It is imperative we continue to ensure fairness to all taxpayers and we appreciate your recognition that using e-filed data for return selection activities could cause disparate treatment of taxpayers that file paper returns.

We recognize the importance of receiving quality information returns. To improve quality through education, we will conduct outreach activities for taxpayers, tax practitioners, tax preparation software companies, and return preparers regarding the proper completion and filing of the Schedule K-1.

We have processes in place that mitigate risk by preventing a Form 1040 from being processed for a decedent taxpayer. This process reduces the risks associated with identify theft and the issuance of erroneous refunds. To improve Schedules K-1 for

2

decedent taxpayers we will update our instructions to clarify how to properly issue a Schedule K-1 when the recipient is deceased.

Attached is a detailed response to address your recommendations. If you have any questions, please contact me or Brenda Dial, Director, Examination Operations, Small Business/Self-Employed Division.

Attachment

Attachment

Recommendation 1:
The Commissioner, Wage and Investment Division, should conduct periodic outreach to encourage submission of reliable Schedule K-1 data to the IRS. Topics should include ***2***
***2**
2
**********2**********The outreach should be directed to those involved with preparing and submitting Schedule K-1 data to the IRS (e.g., flow-through entities, return preparers, tax practitioners, and tax preparation software companies).

Planned Corrective Action:
We agree. We will:
1) Perform outreach activities with affected stakeholders, including the tax preparation software companies.
2) Develop a communication action plan to support periodic outreach directed to flow-through entities, return preparers, and tax practitioners to encourage submission of reliable Schedule K-1 data to the IRS.

Implementation Date:
1) January 15, 2020
1) November 15, 2020

Responsible Officials:
1) Director, Submission Processing, Customer Account Services, Wage and Investment Division
2) Director, Exam Quality & Technical Support, Examination Division, Small Business/Self-Employed Division

Corrective Action Monitoring Plan:
IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 2:
The Commissioner, Wage and Investment Division, should conduct a review to determine the process changes needed to increase the consistency of Schedule K-1 penalty application, especially for ********2******** e-filed Schedules K-1.

Planned Corrective Action:
We agree with this recommendation. A review will be performed to identify where procedural changes may be made to improve the consistency of penalty application for *******2********* filings of the Schedule K-1 family of information returns.

Implementation Date:
March 15, 2020

Responsible Official:
Director, Submission Processing, Customer Account Services, Wage and Investment Division

Corrective Action Monitoring Plan:
IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 3:
The Commissioner, Small Business/Self-Employed Division, should establish a process to use more e-filed Schedule K-1 data for noncompliance identification and determine the feasibility of transcribing more data from paper Schedules K-1.

Planned Corrective Action:
We agree with this recommendation. We will initiate a compliance project using data from e-filed Schedules K-1. We will use the results of that compliance initiative to write a business justification for additional transcription, if appropriate.

Implementation Date:
November 15, 2021

Responsible Official:
Director, Exam Case Selection, Examination Division, Small Business/Self-Employed Division

Corrective Action Monitoring Plan:
IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 4: The Commissioner, Small Business/Self-Employed Division, should enhance the information return ***2*** verification process to ********2********* ******2******* in order to ensure that individuals are properly identified as payees.

Planned Corrective Action:
We disagree with this recommendation. This recommendation will provide minimal benefit to compliance enforcement activities and would require significant programming changes to accomplish. The percent of information returns received by a decedent is very small compared to the entire population of information returns received.

Implementation Date:
N/A

Responsible Official:
N/A

Corrective Action Monitoring Plan:
N/A

Recommendation 5:
The Commissioner, Small Business/Self-Employed Division, should update flow-through form instructions to explain how a flow-through entity should address reporting a deceased recipient and the steps a flow-through entity could take to ensure that accurate recipient information is entered on Schedules K-1 when ownership changes from a deceased recipient.

Planned Corrective Action:
We agree with this recommendation and will update our instructions to provide clearer direction to entities on how to properly issue a Schedule K-1 when the recipient is deceased.

Implementation Date:
November 15, 2020

Responsible Official:
Director, Exam Quality & Technical Support, Examination Division, Small Business/Self-Employed Division

Corrective Action Monitoring Plan:
IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 6:
The Commissioner, Small Business/Self-Employed Division, should conduct periodic outreach to reinforce how Schedule K-1 amounts should be reported on tax returns to prevent underreporter discrepancies. Topics should include when to report Schedule K-1 amounts received from flow-through entities ***********************2********************** ********2********to report Schedule K-1 amounts on tax returns, and **********2********** Schedule K-1 amounts causes potential underreporter discrepancies that may require contact from the IRS to resolve. The outreach should be directed to those involved with preparing and submitting tax returns to the IRS (e.g., taxpayers/flow-through recipients, return preparers, tax practitioners, and tax preparation software companies).

Planned Corrective Action:
We agree with this recommendation and will develop and implement a communication action plan to support periodic outreach for each audience that will reinforce how Schedule K-1 amounts should be reported on tax returns to prevent underreporter discrepancies.

Implementation Date:
November 15, 2020

Responsible Official:
Director, Exam Quality & Technical Support, Examination Division, Small Business/Self-Employed Division

Corrective Action Monitoring Plan:
IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 7:
The Commissioner, Small Business/Self-Employed Division, should add the development of a Business Underreporter (BUR) automated case management system to the Integrated Modernization Business Plan.

Planned Corrective Action:
We agree and have implemented this recommendation. The BUR automated case management system is included as part of our Enterprise Case Management System, which is on the Integrated Modernization Business plan.

Implementation Date:
Implemented

Responsible Official:
Director, Examination, Field and Campus Policy, Examination Division, Small Business/Self-Employed Division

Corrective Action Monitoring Plan:
N/A

Recommendation 8:
The Commissioner, Wage and Investment Division, should ensure that the computer problem that caused amended Schedules K-1 not to be marked as amended on the IRMF has been corrected.

Planned Corrective Action:
We agree with this recommendation and will request programming changes to validate that indicators on the Schedule K-1 family of information returns are accurately recorded when the documents post to the Information Returns Master File. It is anticipated the programming will be completed by January 2021, however, it is subject to Information Technology resource constraints and competing priorities. Consequently, we cannot provide an implementation date.

Implementation Date:
N/A

Responsible Official:
Director, Submission Processing, Customer Account Services, Wage and Investment Division

Corrective Action Monitoring Plan:
IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 9:
The Commissioner, Wage and Investment Division, should establish a process to record Schedules K-1 as amended when submitted with an amended flow-through return, regardless of whether the Schedule K-1 itself is marked as amended.

Planned Corrective Action:
We agree with this recommendation and will determine if the IRS has the legal authority to automatically correct the indicators on the Schedule K-1 family of returns when they do not agree with the type of return with which they are being filed. If legal authority exists, we will submit a request for programming to validate the consistency of the indicators with the parent return and apply the appropriate corrections to the documents. Programming is subject to constrained Information Technology resources and competing priorities. Consequently, we cannot provide an implementation date.

Implementation Date:
N/A

Responsible Official:
Director, Submission Processing, Customer Account Services, Wage and Investment Division

Corrective Action Monitoring Plan:
IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 10:
The Commissioner, Small Business/Self-Employed Division, should establish a process to track the reasons and trends in Automated Underreporter (AUR) closures to identify opportunities to conduct outreach, improve case selection, and update procedures to decrease closures that do not result in tax assessments.

Planned Corrective Action:
We agree and have implemented this recommendation. Annually we complete closed case reviews to identify opportunities to improve case selection. We also regularly participate in practitioner meetings, tax forums, and other meetings (e.g. Tax Talk Today) to discuss the AUR program. We revised our policies in 2017 and 2018 to update guidance when appropriate to reduce no change cases.

Implementation Date:
Implemented

Responsible Official:
Director, Examination, Field and Campus Policy, Examination Division, Small Business/Self-Employed Division

Recommendation 11:
The Commissioner, Small Business/Self-Employed Division, should establish a process to track the reasons and trends in BUR screen out closures to identify opportunities to conduct outreach, improve case selection, and update procedures to decrease screening closures that do not result in tax assessments.

Planned Corrective Action:
We agree and have implemented this recommendation. We complete closed case reviews annually to identify opportunities to improve case selection. Our annual reviews are effective and have reduced screen outs by 37.3%. Outreach is conducted on a case by case basis given the low number of cases included in the program.

Implementation Date:
Implemented

Responsible Official:
Director, Examination, Field and Campus Policy, Examination Division, Small Business/Self-Employed Division