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United States General Accounting Office

Report to the Chairman, Subcommittee on
Commerce, Consumer, and Monetary
Affairs, Committee on Government
Operations, House of Representatives

May 1989

TAX ADMINISTRATION

State and Local Compliance With IRS' Information Reporting Requirements





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-229469

May 4, 1989

The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your January 1988 request that we determine whether state and local governments are complying with the Internal Revenue Service's (IRS) requirements for reporting payments made to independent contractors on information returns. Your concern about compliance with IRS' requirements for filing information returns emerged after you discovered that federal agencies have not been complying with the requirements.

A December 1986 report¹ by the Department of the Treasury's Inspector General to the President's Council on Integrity and Efficiency indicated that 12 of the 14 federal agencies reviewed did not report about \$9 billion of payments to independent contractors in 1984 and 1985 that were subject to information reporting requirements. To check state and local governments' compliance, we visited 17 agencies in 6 states as well as 10 local governments (see app. I).

Results in Brief

The policies and procedures in most of the 17 agencies in 6 states and of the 10 local governments we visited were not in full compliance with IRS' information return requirements, mainly because the responsible officials did not fully understand the requirements.

From our review of payments made to independent contractors by 11 agencies in 4 of the states and by 7 of the local governments, we found that these governments did not report to IRS about \$8 million of \$9 million in payments made during 1985 and 1986 that should have been reported. We also found that IRS has historically done little to ensure that state and local government officials understand and comply with the information return requirements. IRS officials cited the lack of staff

¹Consolidated Audit Report to the President's Council on Integrity and Efficiency Covering the Issuance of Forms 1099 for Nonwage Payments in the Federal Government; Department of the Treasury, Office of the Inspector General; December, 1986; No. OIG 87-18.

State governments can benefit from IRS' information return matching program. IRS has agreements with various states to exchange tax information, which a state may use to, among other things, identify taxpayers who have not reported income or filed tax returns in a state's tax system. As of April 1988, 41 states received IRS information on taxpayers who did not report income.

Nationwide data on payments made by state and local governments to independent contractors do not exist. However, officials in the six state governments we visited during our review estimated that they paid about \$4.7 billion in 1987 to independent contractors just for professional and consultant services. Generally, these payments should be reported to IRS on information returns unless the payments are made to corporations. The state government officials could not identify how much of their estimated payments were made to corporations. As a result, we could not determine how much of the \$4.7 billion paid to independent contractors was actually subject to information reporting requirements.

Objectives, Scope, and Methodology

Our objectives were to determine (1) whether state and local governments comply with IRS' information reporting requirements for payments to independent contractors; (2) the amount that selected state and local governments paid to independent contractors, but did not report to IRS; and (3) what IRS has done to monitor and enforce state and local governments' compliance with the reporting requirements. The information needed to do this review was gathered, to a large extent, through the cooperation of state and local officials. In general, these officials were interested in improving compliance with IRS' information return reporting requirements.

We limited our audit work to 6 states and 10 city or county governments because (1) our findings in most locations were consistent, and (2) IRS and NASACT officials believed that state and local governments' noncompliance with reporting requirements could possibly be widespread. We selected these locations because of the availability of our staff in the geographic areas.

To determine if state and local governments were complying with IRS' reporting requirements, we reviewed the policies and procedures of 17 agencies in 6 states and of 10 local governments we visited. We also interviewed state and local government officials who were responsible

We did our work between May 1988 and September 1988 in accordance with generally accepted government auditing standards.

State and Local Governments' Understanding of IRS' Reporting Requirements Needs to Be Improved

Most state and local governments' policies and procedures were not in full compliance with IRS' requirements for reporting payments made to independent contractors for services. This noncompliance occurred primarily because these governments' officials did not fully understand the requirements. By reviewing policies and procedures and interviewing officials in 17 agencies of the 6 states and in 10 local governments, we found the following:

- The policies and procedures in one state agency and three local governments complied with IRS' information reporting requirements. That is, they correctly required the filing of Form 1099 for payments made to independent contractors for services.
- The policies and procedures in 13 state agencies and 5 local governments partially complied with IRS' reporting requirements. That is, they correctly required the filing of Form 1099 for some, but not for all, payments made to independent contractors for services.
- The policies and procedures in three state agencies and two local governments did not comply with IRS' information reporting requirements. That is, they did not require the filing of Form 1099 for any payments made to independent contractors for services.

Because we found the same types of problems in most of the locations we visited, and because IRS and NASACT have found comparable problems, it seems reasonable to assume that other state and local governments have similar confusion about the reporting responsibilities.

In state and local governments that were not in full compliance, officials whom we interviewed said that they misunderstood the requirements for reporting payments on the basis of the type of business. While they generally understood that payments to individuals have to be reported and payments to corporations do not, they mistakenly assumed that sole proprietors and partnerships that operate under a business name were to be treated like corporations. Therefore, these state and local governments did not report such payments to IRS.

Additionally, these officials said that they did not have a complete understanding of what types of services have to be reported. Because IRS' guidelines clearly subject payments for "professional services" to the reporting requirements, the officials usually reported payments to

Table 1: Payments Made to Independent Contractors by Selected State and Local Governments in Calendar Years 1985 and 1986 and Subject to Information Reporting Requirements

Dollars in thousands			
Reporting requirements	State ^a government	Local ^b government	Total
Required:			
number of contractors	337	127	464
dollars	\$6,855.5	\$1,754.4	\$8,609.9
percent of dollars	16.7	19.7	17.2
Not required:			
number of contractors	362	171	533
dollars	\$33,031.7	\$6,407.2	\$39,438.9
percent of dollars	80.4	71.8	78.9
Not known:			
number of contractors	63	38	101
dollars	\$1,184.2	\$757.1	\$1,941.3
percent of dollars	2.9	8.5	3.9
Total:			
number of contractors	762	336	1,098
dollars	\$41,071.3^c	\$8,918.7	\$49,990.0^c
percent of dollars	100.0	100.0	100.0

^aPayments made by 11 state agencies in 4 states.

^bPayments made by seven local governments in four states.

^cPayments do not add to the totals due to rounding.

As table 1 shows, the state agencies and local governments were required to report 17 percent, or almost \$9 million, of the \$50 million in payments that we reviewed. Seventy-nine percent of this \$50 million was not required to be reported since the payments were made to corporations or other entities exempt from information reporting requirements. For the remaining 4 percent, we could not find adequate records to determine reporting requirements.

Table 2 illustrates high levels of noncompliance among the state agencies and local governments on the payments that should have been reported to IRS. These governments reported only 10 percent, or about \$873,000, of the almost \$9 million that they should have reported.

IRS contracted with NASACT to review compliance in six states that were willing to participate in the review and were acceptable to IRS. NASACT is a professional organization that represents the state officials responsible for financial management and the issues that concern them. IRS intends to make NASACT's review plan available to state government officials so they may determine whether their states comply with information reporting requirements. IRS Examination officials also said they are considering establishment of a focal point in IRS district offices at which state and local government officials could get help in understanding their reporting responsibilities.

In commenting on a draft of our report, NASACT's Executive Director said that as of February 21, 1989, NASACT had finished three of six state reviews. Its work in these three states showed that state governments need to better understand their information reporting responsibilities. Moreover, he noted that compliance with these responsibilities has been hampered by, among other things, states' accounting systems that are not tailored to information reporting. He said that a number of states have expressed interest in NASACT helping them to comply with IRS' reporting requirements.

IRS has not initiated any national projects, comparable to its NASACT study, aimed at improving information reporting by local governments. However, three IRS field offices in northern California have recently reviewed information returns' compliance as part of local special compliance projects. The projects involved contacting city and county governments in northern California counties to determine compliance with information reporting requirements. One field office plans to complete its contacts in early 1989. In the other two field offices, revenue agents completed contacts with eight city and county governments. Of these, four were found to be in compliance with information reporting requirements, while four were not in complete compliance. IRS used these results to educate the four noncompliant local governments about their reporting responsibilities. Officials from these local governments expressed the same types of misunderstandings about when a Form 1099 was required as we found at the state and local governments we visited.

IRS officials said they want to encourage state and local auditors to monitor their governments for compliance with information reporting requirements since IRS does not have the staff to do so. Officials in five state governments we asked said that they did not audit for compliance with information reporting requirements, even though they audit each

Agency Comments and Our Evaluation

In a letter dated March 20, 1989, the Acting Commissioner of Internal Revenue provided written comments on a draft of this report, in which he agreed with our conclusions and recommendations. (See app. III.) He said that IRS is considering the establishment of a focal point in IRS' district offices to assist state and local government officials in understanding their reporting responsibilities.

He also said that IRS is planning to encourage state and local auditors to monitor their governments' compliance with the information return reporting requirements. IRS, through the NASACT study, is looking at ways to have state audit procedures amended to include a check for compliance with these requirements. IRS will also be providing the states with the results of the NASACT study and IRS' reviews of selected local agencies' reporting compliance.

Further, officials in the Office of the Assistant Commissioner (Examination) told us that they plan to periodically monitor state and local government compliance with the information return reporting requirements to determine if compliance has improved or whether additional actions are needed.

IRS' planned actions, if effectively implemented, should improve state and local government officials' understanding of and compliance with the information returns reporting requirements.

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Abbreviations

IRS	Internal Revenue Service
NASACT	National Association of State Auditors, Comptrollers and Treasurers

Appendix I
State Agencies and Local Governments in
Our Review

Virginia	Department of Education Department of General Services Department of Transportation
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Payments Made to
Independent Contractors

Arizona	Department of Administrative Services Department of Transportation Arizona State University
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California	Department of General Services Department of Transportation University of California at Davis University of California at Berkeley
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Florida	Department of Education Department of Transportation University of Florida
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Georgia	Department of Transportation
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Local Governments

Policies and Procedures on Information Reporting	City of Phoenix, AZ Maricopa County, AZ City of San Francisco, CA City of Santa Rosa, CA City of Tallahassee, FL Leon County, FL Seminole County, FL City of Atlanta, GA Gwinnett County, GA Fulton County, GA
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Excerpt From IRS' Guidelines for Information Reporting (IRS Publication 916, Information Returns)

Guidelines for reporting nonemployee compensation. Generally, if you answer "yes" to the 4 questions below, you must report a payment as nonemployee compensation on Form 1099—MISC.

- 1) Did you make the payment to a nonemployee?
- 2) Did you make the payment for services rendered in your trade or business (including government agencies and nonprofit organizations)?
- 3) Did you make the payment to a payee who is not a corporation? (If the payment was made to a corporation, see *Corporations and partnerships* on page 1.)

Note: Treat a payee as a corporation if the name of the payee ends with the corporate status, such as *Incorporated, Inc., Corporation, or Corp.* Do not treat a payee as a corporation if the payee's name ends with *Company or Co.,* or ends without any business status.

- 4) Did the payments total \$600 or more during the year? (Total payments include payments for parts or materials used by the payee in rendering the services.)

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX ADMINISTRATION: STATE AND LOCAL COMPLIANCE WITH
IRS' INFORMATION REPORTING REQUIREMENTS"

Recommendation 1: Establish an IRS focal point to provide assistance to those state and local government officials needing further clarification or elaboration of their reporting responsibilities.

Comment:

We agree with the recommendation. As noted on page 18 of the report, "IRS Examination officials also said they are considering establishment of a focal point in IRS district offices at which state and local government officials could get help in understanding their reporting responsibilities."

Recommendation 2: Encourage state and local audit agencies to routinely check the agencies they audit for information returns compliance.

Comment:

We agree with the recommendation. As noted on page 19 of the report, "IRS officials said they want to encourage state and local auditors to monitor their governments for compliance with information reporting requirements since IRS does not have the staff to do so." Amending state audit procedures to include a check for compliance with information return reporting requirements is being addressed in the NASACT study.

Recommendation 3: Use the NASACT study of six states and the IRS reviews of California local governments to aid in the development of an IRS program for monitoring and enforcing state and local governments' information returns compliance.

Comment:

We agree with this recommendation. As noted in the report, IRS plans to provide the NASACT review of six states and its own review of selected local agencies to encourage state and local auditors to monitor their governments' compliance with information reporting requirements.

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Comments From the Internal Revenue Service



COMMISSIONER

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

MAR 26 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled "Tax Administration: State and Local Compliance with IRS' Information Reporting Requirements".

We agree with the report's recommendations and with the report's conclusions that more could be done to monitor state and local compliance with information reporting requirements. Because of the need to devote our limited resources to higher priority compliance programs, we contracted with the National Association of State Auditors, Comptrollers and Treasurers (NASACT) to review selected state information reporting procedures and compliance with these procedures. IRS plans to provide NASACT's review plan to all states in order to encourage them to undertake their own compliance reviews. We support efforts of state and local auditors to monitor their agencies' compliance with information reporting requirements. We agree with state audit officials that they are in the best position to check such compliance as part of their more general state and local audits. Our detailed comments are enclosed.

We hope you find these useful.

With best wishes.

Sincerely,

A handwritten signature in cursive script, appearing to read "Charles B. Remon".

Acting Commissioner

Enclosure

Appendix I
State Agencies and Local Governments in
Our Review

Payments Made to
Independent Contractors

City of Phoenix, AZ
Maricopa County, AZ
City of San Francisco, CA
City of Santa Rosa, CA
City of Tallahassee, FL
Seminole County, FL
Gwinnett County, GA

State Agencies and Local Governments in Our Review

The following lists identify state agencies and local governments we visited to review (1) policies and procedures on information reporting and (2) payments made to independent contractors.

State Agencies

Policies and Procedures on Information Reporting

Arizona	Department of Administrative Services Department of Transportation Arizona State University
California	Department of General Services Department of Transportation University of California at Davis University of California at Berkeley
Florida	Department of Banking and Finance ³
Georgia	Department of Administrative Services Department of Education Department of Transportation
Maryland	Department of Education Department of General Services Department of Transportation

³In the state of Florida, the Department of Banking and Finance maintains responsibility for payments and the related policies and procedures. We visited this department to review the statewide policy and procedures, but while there, we reviewed payments made by three separate state entities.

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As arranged with the Subcommittee, unless you publicly announce its results earlier, we plan no further distribution of this report until 30 days from the date of issuance. At that time, we will send copies of the report to the Commissioner of Internal Revenue and other interested parties and will make copies available to others upon request.

This report was prepared under the direction of Jennie S. Stathis, Director, Tax Policy and Administration Issues. Other major contributors are listed in appendix IV.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Richard L. Fogel". The signature is written in a cursive, flowing style.

Richard L. Fogel
Assistant Comptroller General

agency within their states annually or biannually. The issue of amending audit procedures to include a check for compliance with information return reporting requirements is being addressed in the NASACT study.

Conclusions

IRS has done little over the years to ensure that state and local governments understand and comply with information reporting requirements. Millions of dollars in payments made to independent contractors by state and local governments are subject to information reporting requirements, but the payments are not being reported to IRS because the responsible officials do not fully understand the requirements.

IRS recognizes the need to do more to monitor and assist state and local governments in complying with the reporting requirements. It has recently contracted for the study of six state governments' compliance with the reporting requirements. IRS has also incorporated our guide into its instructions for tax year 1988 to help state and local officials identify payments made to independent contractors that are subject to information reporting requirements.

While we view these actions as good first steps, IRS also needs to take action to ensure that responsible governmental officials across the country both better understand and comply with their reporting responsibilities. For example, by establishing a district office focal point to provide assistance or information, IRS could better help state and local government officials.

Recommendations

We recommend that the Commissioner of Internal Revenue take the following actions:

- Establish an IRS focal point to provide assistance to those state and local government officials needing further clarification or elaboration on their reporting responsibilities.
- Encourage state and local audit agencies to routinely check the agencies they audit for information returns compliance.
- Use the NASACT study of six states and the IRS reviews of California local governments to aid in the development of an IRS program for monitoring and enforcing state and local governments' information returns compliance.

Table 2: Reporting of Required Payments for Services by Selected State and Local Governments in Calendar Years 1985 and 1986

Dollars in thousands			
Reporting of required payments	State ^a government	Local ^b government	Total
Reported:			
number of contractors	7	54	61
dollars	\$60.7	\$812.3	\$872.9 ^c
percent of dollars	0.9	46.3	10.1
Not reported:			
number of contractors	330	73	403
dollars	\$6,794.8	\$942.2	\$7,737.0
percent of dollars	99.1	53.7	89.9
Total:			
number of contractors	337	127	464
dollars	\$6,855.5	\$1,754.4^c	\$8,609.9
percent of dollars	100.0	100.0	100.0

^aPayments made by 11 state agencies in 4 states.

^bPayments made by seven local governments in four states.

^cPayments do not add to the totals due to rounding.

We believe that the amount that state and local governments pay to independent contractors but do not report to IRS will increase as governmental entities contract out more services. According to a 1987 survey of city and county governments, nearly 80 percent of the respondents to a questionnaire had contracted, within the past 5 years, with private organizations to provide basic municipal services.² The services most frequently contracted out were solid-waste collection or disposal, vehicle towing or storage, and building or grounds maintenance. These respondents said that their expenditures for such contracts are likely to increase over the next 2 years. Payments for these services are reportable on Form 1099 if the contractor is not a corporation.

IRS Does Not Monitor State and Local Government Compliance

According to IRS officials, IRS has not had a program designed to examine state and local governments' compliance with information reporting requirements. IRS procedures require its auditors to check for information returns compliance when they examine businesses' income tax returns. Because state and local governments do not file income tax returns, they have not been audited.

IRS recognizes the need to administratively monitor states' compliance with requirements for reporting information returns. In August 1988,

²Touche Ross and Co., *Privatization in America: An Opinion Survey of City and County Governments on Their Use of Privatization and Their Infrastructure Needs*, 1987.

architects, engineers, attorneys, and consultants. But the officials did not report payments for construction services, auto repairs, janitorial services, and landscaping service, among others. These services also fall within IRS reporting requirements; however, the officials did not consider these services to be "professional."

From our review of payments, we developed a guide for identifying payments to independent contractors that should be reported to IRS. The guide includes four criteria common to all payments for services that should be reported. IRS agreed that such a guide would be useful for identifying payments that are subject to information reporting. It has included this guide in its tax year 1988 instructions to taxpayers on information return requirements. (See app. II.)

State and Local Governments' Failure to File Form 1099 May Be Costing the Federal Government Millions of Dollars

Federal tax revenues may be millions of dollars lower because state and local governments are not reporting payments made to independent contractors. The lack of nationwide data on such payments kept us from projecting the amounts of payments that should be, but are not, reported, along with associated tax revenue losses. Regardless, our work in a few state agencies and local governments uncovered millions of dollars in unreported payments. Our work suggests that widespread non-compliance with reporting requirements may exist among state and local governments. Given 50 states and thousands of local governmental units, the potential for millions of tax dollars lost due to noncompliance is high.

To get an indication of the amount of payments that should have been reported to IRS, we reviewed about \$50 million in payments made to 1,098 independent contractors during 1985 and 1986. The payments were made by 11 agencies in 4 states and by 7 local governments. Table 1 shows the number of independent contractors receiving payments and the amounts of those payments that were required to be reported.

for reporting payments to IRS to discuss their understanding of the reporting requirements.

To determine the amounts that state and local governments paid to independent contractors, but did not report to IRS, we reviewed available information on payments made to independent contractors by the governments we visited. This approach does not allow us to statistically project our results beyond the payments we reviewed. However, it was necessary since the available information on payments by these state and local governments was not adequate to permit selection of a random sample. For example, the available accounting records did not segregate all payments made for services versus material goods or payments made to sole proprietors, partnerships, or corporations.

Because of constraints with the accounting records and limitations in the time and staff available for doing our analysis, we limited our review of these payments to four of the state governments and seven of the local governments we visited. In the 4 state governments, we reviewed payments made by 11 state agencies, including state universities. These agencies were responsible for highway construction, general administrative functions, and education. We selected these agencies because our initial work showed that they would have a high likelihood for using independent contractors.

Using the available information, we reviewed payments to 1,416 independent contractors, of which 1,098 received payments for services of \$600 or more during 1985 or 1986, to determine whether the payments should have been reported to IRS. For payments to the 1,098, we also analyzed detailed agency records, such as invoices or purchase orders. If necessary, we contacted independent contractors to determine their business structure, i.e., sole proprietor, partnership, or corporation. For payments that we determined should have been reported, we also reviewed IRS data to see whether they were reported. The payments to the 1,098 independent contractors totaled about \$50 million for 1985 and 1986—the most current years for which the payment data could be checked against IRS' data.

To determine how well IRS monitors and enforces compliance with information return requirements, we reviewed IRS examination policies and procedures and interviewed IRS officials responsible for information returns compliance in IRS' national office and in four district offices.

as the reason for having done little to monitor state and local governments' information return compliance.

IRS and the National Association of State Auditors, Comptrollers and Treasurers (NASACT) agree that problems with monitoring and compliance exist. In an effort to improve state and local government compliance with the information return requirements, in August 1988 IRS contracted with NASACT to review information return procedures and compliance levels in six states, including two states we visited. IRS plans to provide all 50 states with a consolidated report on NASACT's 6 state reviews, along with a model review plan, and encourage them to do compliance reviews.

Background

Independent contractors provide services to a business or government agency, but they are not employees. They may organize their businesses and offer their services as either sole proprietors, partnerships, or corporations. Payments made to sole proprietors and partnerships for services are subject to information returns reporting. Payments to corporations, except those made for medical services, are exempt from information returns reporting. IRS guidelines also explicitly exempt most payments made for material goods.

IRS requires businesses and governments to annually report payments of \$600 or more made to independent contractors for services rendered. Payments that must be reported to IRS on Form 1099—MISC (Miscellaneous Income) include commissions, fees, or other forms of compensation for services. Failure to report these payments may result in penalties. For example, IRS may assess a \$50 penalty for each failure to file a Form 1099 with IRS, or failure to furnish a copy of the Form 1099 to the independent contractor.

IRS matches these and other types of information returns to federal income tax returns to identify taxpayers who may have underreported income or have not filed tax returns. If a mismatch occurs, IRS usually contacts the taxpayer to resolve the discrepancy. IRS' studies show that when information returns were issued by any employer making payments, taxpayers reported about 97 percent of the income. However, when the returns were not issued, taxpayers reported only about 83 percent of the income.

