United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

August 2010

TAX GAP

IRS Has Modernized Its Business Nonfiler Program but Could Benefit from More Evaluation and Use of Third-Party Data

GAO
Accountability * Integrity * Reliability

GAO-10-950

GAO Highlights

Highlights of GAO-10-950, a report to the Committee on Finance, U.S. Senate.

Why GAO Did This Study

The Internal Revenue Service (IRS) does not know how many businesses failed to file required returns, nor does it have an estimate of the associated lost tax revenue—the business nonfiling tax gap. Many cases it does investigate are unproductive because the business does not owe the return IRS expects. GAO was asked to assess (1) the data challenges of estimating the business nonfiler tax gap, (2) how recent program changes have affected IRS's capacity to identify and pursue business nonfilers, and (3) additional opportunities for IRS to use third-party data. GAO reviewed IRS's tax gap estimates, nonfiler program processes and procedures, and matched closed nonfiler cases with various other data.

What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue develop a partial business nonfiler rate estimate; set a deadline for developing performance data; develop a plan for evaluating the selection codes; reinforce the need to use income data and selection codes in verifying taxpayer statements; and study the feasibility and cost-effectiveness of using non-IRS data to verify taxpayer statements.

In written comments on a draft of this report IRS agreed that identifying and pursuing active business nonfilers is key to enforcement efforts and acknowledged that our recommendations could assist these efforts. IRS agreed with four of GAO's recommendations and indicated some steps it would take to address the other four.

View GAO-10-950 or key components.

For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

August 2010

TAX GAP

IRS Has Modernized Its Business Nonfiler Program but Could Benefit from More Evaluation and Use of Third-Party Data

What GAO Found

IRS cannot develop a comprehensive estimate of the business nonfiling rate and associated tax gap because it lacks data about the population of all businesses. However, IRS could develop a partial estimate using its business nonfiler inventory. IRS identifies several million potential business nonfilers each year, more than it can thoroughly investigate. IRS could take a random sample of its inventory, thoroughly investigate those cases, and use the results to estimate the proportion of actual nonfilers in its inventory of potential nonfilers.

Until recently IRS has not had a way to prioritize cases in its large inventory. IRS modernized its business nonfiler program in 2009 by incorporating income and other data in its records indicating business activity. Active businesses generally have an obligation to file a return. IRS's Business Master File Case Creation Nonfiler Identification Process (BMF CCNIP) now assigns each case a code based on this data. IRS uses the code to select cases to work with the goal of securing tax returns from nonfilers and collecting additional revenue.

This is a significant modernization, but IRS lacks a formal plan to evaluate how well the codes are working. IRS has performance information on its individual nonfiler program but less on its business nonfiler program. Key management reports needed to provide program data are under development but no deadline has been set. IRS could also use more information on why many nonfiler cases are unproductive. This could potentially lead IRS to identify actions that could reduce IRS resources used on these cases and associated taxpayer burden.

GAO identified several opportunities including the following to enhance IRS's identification and pursuit of business nonfilers.

- The new BMF CCNIP selection codes provide a quick way to verify taxpayer statements that a business has ceased operations and does not need to file a return. Collections staff have been instructed to use the codes when making case closure decisions. They were previously instructed to use other income data but GAO's analysis indicated this may not have been done in all cases.

- Non-IRS data on businesses including federal contractors could be used to verify taxpayer statements about whether a tax return should have been filed. GAO's analysis of cases in two states that were closed as not liable to file a return found 7,688 businesses where non-IRS data showed business activity as measured by sales totaling $4.1 billion. GAO also found cases closed as not liable to file a return involving 13,852 businesses on the federal contractor registry. GAO's analyses illustrated the potential value of non-IRS data but GAO did not assess which non-IRS data would be most useful nor examine the capacity of IRS's systems to use such data on a large scale.

Contents

Figures

Abbreviations

A6020(b)	Automated 6020(b) program
ACS	Automated Collection System
AIR	Aggregated Information Return
BMF	Business Master File
BMF CCNIP	Business Masterfile Case Creation Nonfiler Identification Process
CAWR	Combined Annual Wage Reporting
CCR	Central Contractor Registration
CSCO	Compliance Services Campus Organization
D&B	Dun and Bradstreet
EIN	Employer Identification Number
FERDI	Federal Employee/Retiree Delinquency Initiative
FICA	Federal Insurance Contribution Act
FPLP	Federal Payment Levy Program
IDS	Inventory Delivery System
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
NAP	National Accounts Profile
NFEAC	Nonfiler Executive Advisory Council
NRP	National Research Program
PMF	Payer Master File
RAS	Research, Analysis, and Statistics
SBSE	Small Business/Self-Employed
SRFMI	State Reverse File Match Initiative
TIC	Type Indicator Codes
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number

United States Government Accountability Office
Washington, DC 20548

August 31, 2010

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

In fiscal year 2009, businesses filed 14 million income tax returns and 30 million employment tax returns and remitted over $1 trillion in federal taxes. While the Internal Revenue Service (IRS) catches some nonfilers, it does not know how many businesses failed to file returns that they should have filed nor does it have an estimate of the business nonfiling tax gap, which is the amount of tax revenue associated with returns that were not filed.[1] IRS's most recent tax gap estimates for tax year 2001 include an estimate of $25 billion in revenue loss due to nonfiling by individuals.

The lack of an estimate of the business nonfiling tax gap matters because the tax gap estimate is routinely used as a measure of the total amount of tax noncompliance IRS needs to address.[2] Without a tax gap estimate for business nonfiling, there is no way to know whether IRS's strategy to reduce the tax gap, including its resource allocation decisions, places appropriate priority on this type of noncompliance relative to others. Further, nonfiling of required tax returns and nonpayment of taxes owed is not fair to businesses and individuals who do file returns and pay their taxes.

Historically, IRS has identified more potential business nonfilers than it can thoroughly investigate through its enforcement programs. For tax year 2007, IRS had identified almost 2 million businesses as potential nonfilers whose cases had not been resolved as of June 2009. Until recently IRS has

[1]IRS defines the tax gap as the difference between what taxpayers pay voluntarily and on time and what they should pay under the law. This is the gross tax gap. IRS also publishes an estimate net of all receipts. Unless noted, in this report the tax gap is defined as the gross tax gap. While IRS does not have an estimate of the business nonfiling tax gap, it does have an estimate for estate tax nonfiling.

[2]See, for example, GAO, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic Approach to Reducing the Tax Gap*, GAO-05-573 (Washington, D.C.: July 18, 2005).

not had a way to prioritize the millions of potential nonfiler cases it identifies each year. After several years of study IRS modernized its business nonfiler program in 2009 by incorporating data about businesses indicating business activity and a likely filing requirement. IRS's Business Masterfile Case Creation Nonfiler Identification Process (BMF CCNIP) now assigns each case a code based on these data. IRS uses the code to select cases to work with the goal of securing tax returns from nonfilers and collecting additional revenue.

Because of your interest in IRS's business nonfiler program and IRS's use of information returns, you asked us to assess (1) the data challenges of estimating the business nonfiler tax gap, (2) how recent program changes in IRS's processes and procedures have affected its capacity to identify and pursue business nonfilers, and (3) what opportunities exist for IRS to improve its use of third-party information returns or other sources to identify and pursue business nonfilers.

To meet our report's objectives, we conducted an evaluation involving multiple elements including document review, data analysis, and interviews. To assess the data challenges of estimating the business nonfiler gap, we reviewed GAO and Treasury Inspector General for Tax Administration (TIGTA) reports, IRS documents on the tax gap, past research on the tax gap and business nonfilers; analyzed IRS operational data; and interviewed IRS research officials. To assess how recent program changes in IRS's processes and procedures have affected its capacity to identify and pursue business nonfilers, we reviewed program documents pertaining to IRS's new business nonfiler program, portions of the *Internal Revenue Manual*, and IRS documents on its Nonfiler Strategy and its implementation. We also observed IRS's collections functions at IRS's Philadelphia service center, and interviewed officials involved in the program. To assess what opportunities exist for IRS to improve its use of third-party information returns or other sources to identify and pursue business nonfilers, we identified non-IRS data sources—including government contractor data and private third-party data—that could have information on business nonfilers and assessed the potential of this information to help IRS better identify and pursue business nonfilers. We matched closed nonfiler cases from businesses located in California and Illinois against Dun and Bradstreet (D&B) data to determine whether private sector data could be useful for IRS.[3] The data we include in our analysis are IRS data from BMF records, the Central Contractor Registration (CCR) database, and D&B data. Detailed information about our methodology can be found in appendix I.

We conducted this performance audit from March 2009 through August 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

IRS Requires Various Types of Tax Returns from Business Entities Depending on Their Form and Activities

Many businesses, including corporations, partnerships, and any business that has employees, are required to request an Employer Identification Number (EIN) from IRS to be used in filing returns.[4] Entities that must file business returns include corporations, partnerships, trusts, estates of decedents, and government agencies.[5] On its EIN application, a business gives IRS information about its structure and whether or not it has employees. Based on this information, IRS establishes an account for the business, notifies the business of its EIN and filing requirement, and records its filing requirement on IRS's BMF. The filing requirements on the BMF are the basis for IRS's efforts to ensure that businesses file their required returns. Businesses may have to file several types of returns. A business that does not file the return in IRS's records by the due date

[3] We judgmentally selected these two states to get a geographic mix of states that had sufficient cases that were closed as not liable to file tax year 2007 returns to test the viability of using private sector data.

[4] A business may request an EIN on-line or by using Form SS-4.

[5] IRS considers employers, sole proprietors, corporations, partnerships, tax-exempt organizations, trusts, estates of decedents, and other entities to be businesses. Sole proprietors, however, do not file business income tax returns. Rather, sole proprietors report the income and expenses of the business on a schedule attached to their individual tax returns but may be required to file other types of business tax returns, e.g., employment or excise taxes, for which they need an EIN.

including any extensions is considered by IRS to be a potential nonfiler.[6] This is the case including where the business has filed a different return than the one IRS expects, e.g., where a partnership has restructured itself as a corporation and filed a corporate return. (For more information on selected business returns and restructuring, see app. II.)

Employment taxes from employers and employees account for the largest share of revenue collected from businesses. Employment tax returns report income taxes withheld on behalf of employees, the employees' share of Federal Insurance Contribution Act (FICA) taxes, that is, Social Security and Medicare taxes, and the employer's matching share of FICA taxes. A business with employees, regardless of its structure, is generally required to file employment tax returns. In fiscal year 2009, IRS collected an estimated $792.8 billion in FICA taxes and $880.8 billion in individual income tax withholding, or 71.4 percent of all federal tax collections.

Businesses also may be required to file an annual return reporting income and losses. Businesses structured as C corporations[7] are generally required to file annual income tax returns including when they did not have taxable income. C corporations pay the corporate income tax.[8] Other types of businesses including businesses structured as S corporations and partnerships are required to also file annual returns, but their income is

[6]This is the Servicewide definition of a nonfiler in IRS's Nonfiler Strategy, discussed later in this report.

[7]A corporation is a legal construct (often a business entity) created in conformance with statutory requirements that acts as a separate and distinct legal entity apart from its owners and that has other legal rights such as the ability to own property, enter into contracts, and issue stock. Typically, a corporation's shareholders have limited liability, meaning they are not personally liable for the debts of the corporation beyond their investment. Under the Internal Revenue Code, corporations are classified as C corporations or S corporations. A corporation can elect to be treated as an S corporation for tax purposes if it meets certain eligibility requirements, including having no more than 100 shareholders. 26 U.S.C. § 1361. In recent years S corporations have been one of the fastest growing business entity types. See GAO, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules*, GAO-10-195 (Washington, D.C.: Dec. 15, 2009). Any corporation not eligible or not electing to be treated as an S corporation is treated as a C corporation. Generally, income earned by C corporations is taxed at the corporate tax rate at the corporate level. In addition, distributions to stockholders are taxed as income at the shareholders' rates.

[8]26 U.S.C. § 6012(a)(2); 26 C.F.R. § 1.6012-2.

not taxable at the business level.[9] Rather, income and losses are generally passed through to others, e.g., to the shareholders of an S corporation or the partners of a partnership.[10]

Many businesses are also required to file third-party information returns about various payments they make. Payments subject to information reporting include interest earned from banks, mortgage interest paid, wages paid, and some payments to contractors.

Over 30 types of information returns are filed on businesses. For tax year 2008, IRS received 421.5 million such returns. Of these, about 347.5 million, or about 80 percent of all information returns filed on businesses, reported broker and barter transactions (Form 1099B).[11] IRS also receives information returns on the amount of federal contract obligations made to businesses awarded federal contracts.[12]

[9]In general, all domestic partnerships that have income, deductions, or credits for federal income tax purposes during a tax year must file a return of partnership income (Form 1065) for that year. 26 U.S.C. § 6031(a); 26 C.F.R. § 1.6031(a)-1(a). This requirement encompasses entities such as limited liability corporations that are treated as partnerships for federal income tax purposes. Certain eligible syndicates, pools, or joint ventures, such as investing and operating agreement partnerships, may elect not to be treated as a partnership for federal income tax purposes and are not required to file a Form 1065, although their members must still report their share of the partnership's income. 26 C.F.R. §§ 1.761-2, 1.6031(a)-1(c). Certain publicly traded partnerships are treated as corporations and file Form 1120. 26 U.S.C. § 7704. Foreign partnerships are generally only required to file if the partnership had gross income from a source within the United States or income effectively connected with the conduct of a trade or business within the United States. 26 U.S.C. § 6031(e); 26 C.F.R. § 1-6031(a)-1(b).

[10]The information returns reporting income are known as Form K-1s. See GAO, *Tax Administration: IRS Should Take Steps to Improve the Accuracy of Schedule K-1 Data*, GAO-04-1040 (Washington, D.C.: Sept. 30, 2004) and *Tax Administration: Changes to IRS's Schedule K-1 Document Matching Program Burdened Compliant Taxpayers*, GAO-03-667 (Washington, D.C.: May 30, 2003).

[11]These totals include information returns filed on sole proprietors where the sole proprietor withholds FICA and income tax under an EIN that is the tax identification number for the business.

[12]Federal agencies use Form 8596 to report this information. See GAO, *Tax Administration: More Can Be Done to Ensure Federal Agencies File Accurate Information Returns*, GAO-04-74 (Washington, D.C.: Dec. 5, 2003).

Recent IRS Actions Seek to Address Long-Standing Business Nonfiler Issues

GAO,[13] TIGTA,[14] and IRS itself have documented long-standing issues with IRS's business nonfiler compliance activities. Each year IRS identifies a large number of potential business nonfiler cases, more than IRS has the capacity to work. Many cases go unresolved, and many that IRS does pursue are closed with a determination that the business does not owe IRS a return—a generally unproductive use of IRS's enforcement resources.

In 2005 TIGTA found that IRS's nonfiler efforts for individuals and businesses were fragmented and recommended that IRS develop a coordinated national strategy. Following TIGTA's report, in August 2007 IRS adopted a Servicewide Nonfiler Strategy, governed by the IRS Enforcement Committee. The Strategy recognized that large inventories and pursuit of unproductive business nonfiler cases continued to present challenges. The Strategy further noted that IRS did not apply resources to more productive business nonfiler cases but rather to cases closed with a determination that the taxpayer did not owe IRS a tax return. As one of several goals, the Strategy proposed to expand the use of third-party information and research tools to enhance identification, selection and resolution of nonfiler cases. The Strategy also set a goal of developing and implementing consistent Servicewide performance and outcome measures to determine the impact of its initiatives on filing compliance.[15]

To provide Servicewide oversight for all IRS nonfiler initiatives and actions, IRS established the Nonfiler Executive Advisory Council (NFEAC), a Servicewide body chartered by the IRS Enforcement Committee and consisting of representatives from all IRS divisions. The NFEAC was to coordinate nonfiler initiatives across IRS's operating divisions. In addition, its mission included developing, monitoring, and measuring the effectiveness of the Strategy across all IRS divisions.

[13]See GAO, *Tax Administration: Improving IRS' Business Nonfiler Program*, GAO/GGD-89-39 (Washington, D.C.: Mar. 8, 1989) and *Tax Administration: IRS Could Reduce the Number of Unproductive Business Nonfiler Investigations*, GAO/GGD-88-77 (Washington, D.C.: May 24, 1988).

[14]See Treasury Inspector General for Tax Administration, *The Internal Revenue Service Needs a Coordinated National Strategy to Better Address an Estimated $30 Billion Tax Gap Due to Nonfilers* (Reference No. 2006-30-006, Nov. 22, 2005) and *Additional Steps Need to be Completed to Ensure the Success of the Service-wide Non-filer Strategy* (Reference No. 2008-30-165, Sept. 22, 2008).

[15]TIGTA's 2008 report following up on the implementation of IRS's Nonfiler Strategy found that Servicewide performance measures needed to be developed.

Following adoption of the Nonfiler Strategy, IRS developed several nonfiler initiatives affecting how it identifies and pursues nonfilers. The initiative aimed at addressing long-standing business nonfiler issues is the Business Master File Case Creation Nonfiler Identification Process (BMF CCNIP). This project, implemented in April 2009, uses third-party information data and IRS account data to select potential business nonfiler cases for pursuit based on the likelihood of securing returns and revenue. This change represents a modernization of IRS's business nonfiler compliance activities as well as the introduction of a concept—use of information return data—we have long endorsed.[16] (For additional information on IRS's process for identifying and pursuing business nonfilers, see app. III.)

The Nonfiler Strategy also envisioned that IRS would use state data in its nonfiler activities. IRS officials told us that IRS originally planned to expand BMF CCNIP to include use of state tax information in its business nonfiler activities, ultimately from IRS's State Reverse File Match Initiative (SRFMI), an initiative aimed at matching state and federal taxpayer data to identify noncompliance with federal tax law by individual and business taxpayers.[17] Another expansion was to develop business rules that would close cases where filing requirements no longer existed. At the time we finished our work, no documentation was available on the planned expansions, and IRS officials told us that these were on hold pending funding.

[16]See GAO, *The Merits of Establishing a Business Information Return Program*, GAO/T-GGD-87-4 (Washington, D.C.: Mar. 17, 1987); *IRS Needs to Implement a Corporate Document Matching Program*, GAO/T-GGD-91-40 (Washington, D.C.: June 10, 1991); and *Tax Administration: Benefits of a Corporate Matching Program Exceed the Costs*, GAO/GGD-91-118 (Washington, D.C.: Sept. 27, 1991).

[17]See GAO, *Tax Administration: IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program*, GAO-09-45 (Washington, D.C.: Nov. 7, 2008). Several pilot phases have been completed. As of January 2010, in response to our recommendation, IRS had completed a plan to evaluate the pilot.

A Comprehensive Estimate of the Business Nonfiling Tax Gap May Be Infeasible, but IRS Operational Data Could Provide Partial Information

According to IRS, the primary challenge for IRS in developing a business tax gap estimate is a lack of data. IRS officials told us IRS has no plans to develop a business nonfiler estimate due to a lack of the necessary data. They said that IRS's tax gap estimates for individual and estate nonfiling were comprehensive,[18] but data similar to that used in those estimates do not exist for businesses. According to IRS officials we spoke with and an expert on tax gap estimation issues we consulted, no comparable population data set of all U.S. businesses exists and developing one would be very expensive. IRS officials we spoke with identified a number of alternative methods for conducting a comprehensive study of the business nonfiler tax gap, but also stated that these studies would be costly, overly complex, or inconsistent with other estimates.

We agree that a comprehensive approach may not be feasible, but there may be ways IRS could build a partial estimate of business nonfilers. A partial estimate could be based on IRS's inventory of over 40 million potential nonfiler cases. IRS does not know what share of its inventory represents instances of actual nonfiling. On the basis of IRS's historical experience, many of the businesses in the inventory do not have a current filing requirement. For example, they may have closed, merged with another business, no longer have employees, or filed under a different EIN. Table 1 shows IRS's inventory for selected business return types.

Table 1: IRS's Inventory of Potential Business Nonfiler Cases by Selected Return Type as of the End of Calendar Year 2009

	Employment tax (Form 941)	Unemployment tax (Form 940)	Corporate income tax (Form 1120)	Partnership return (Form 1065)	Estate tax return (Form 1041)	Excise tax return (Form 720)
Number of potential cases	25,315,033	3,878,431	5,080,271	3,825,244	5,668,713	346,971

Source: IRS.

Notes: In this table, a case involves an instance of nonfiling of one return. Cases shown are in the BMF CCNIP inventory, which includes all identified instances of business nonfiling whether or not selected for pursuit.

IRS could estimate the extent of actual nonfiling among businesses with EINs by taking a sample of each type of return, such as C and S corporation returns, from this inventory and thoroughly investigating

[18]IRS's National Research Program (NRP) updates the tax gap estimates. Its nonfiling estimates seek to estimate noncompliance by all nonfilers, both those known to IRS and those unknown. A comprehensive effort to measure compliance for different types of taxes and various sets of taxpayers, the NRP is intended to provide a statistically valid representation of the compliance characteristics of taxpayers.

them. The results would not be comparable to IRS's estimate for individual nonfiling because they would not include businesses not already in the inventory, but this study would begin to quantify the extent of business nonfiling and could give IRS a better basis to decide what priority it should place on this type of noncompliance. Despite its limitations, this type of estimate could give IRS information that would be useful in its long-term strategic planning. If done with a sufficient sample size, IRS could determine the characteristics of nonfiling entities and use this information to make changes to its nonfiler compliance activities as appropriate. On the basis of the results of this work, IRS could then decide whether the benefits of a larger study to quantify the revenue impact of business nonfiling would outweigh the costs.

More Performance Information and Evaluation Is Needed to Measure the Success of IRS's Business Nonfiler Program

As previously noted, IRS has already taken actions to address the long-standing issues presented by business nonfilers. The BMF CCNIP represents a significant modernization of IRS's business nonfiler compliance program. BMF CCNIP's use of information return and account data for the first time gives IRS a way to identify those potential nonfilers most likely to be active businesses. Prioritizing business nonfiler cases based on information return and account data could increase productivity without any increase in resources. In addition to the BMF CCNIP, IRS has developed overall performance measures that could be used to gauge the success of the full range of its business nonfiler compliance activities, from identification through case selection through pursuit by IRS's collections functions. However, IRS does not have all the information it needs to know how well the new initiative is working.

Information on the Results of IRS's New Modernized Business Nonfiler Program Is Not Yet Available

As the BMF CCNIP was being designed, IRS developed goals and measures that could be used to assess its progress. A key goal for the BMF CCNIP was a 50-percent reduction in the number of unproductive cases.[19] This was based on an IRS research finding that where businesses had information return data, closures of cases as "not liable to file a return" were reduced by 50 percent. In 2006, IRS developed a Performance Management Plan for the BMF CCNIP which established performance measures aligned to the IRS Strategic Plan and identified sources of data

[19] See GAO, *Tax Debt Collection: IRS Has a Complex Process to Attempt to Collect Billions of Dollars in Unpaid Tax Debt*, GAO-08-728 (Washington, D.C.: June 13, 2008), appendix III.

that could be used to monitor the goals. This plan stated that baseline data to track progress towards goals would be from 2005.

IRS officials told us that BMF CCNIP management reports and data needed to gauge program performance were not yet available. A key report that will show information on resolution type for each case, selection code, return type, whether the return was secured, and revenue collected with the return was planned. IRS plans to use the report in assessing the effectiveness of the selection codes and tracking the volume of cases closed as not liable to file a return. Officials did not know when the report would be available. As of June 2010, BMF CCNIP staff were working on developing the specifications for this report, and no deadline for its completion had been set. BMF CCNIP management reports that were operational at the time we finished our work were being used to monitor workload, for example, by return type, selection code, and the IRS service center that processed the case. In discussing plans to assess the BMF CCNIP, officials also said that using data from before the start of the CCNIP would be difficult and baseline program data to track progress would come from 2010.

IRS officials said that until additional BMF CCNIP management reports are developed they were using other routine reports to monitor the response rate to business nonfiler notices as an indicator of BMF CCNIP effectiveness. Officials said the response rate to notices had doubled since the start of BMF CCNIP, increasing from about 15 percent to about 30 percent. Officials interpreted this increase as showing that the new system is having a positive impact but noted that it was too soon to identify a trend.

IRS Has Performance Information for Its Individual Nonfiler Program but Not for Its Business Nonfiler Program

In addition to measures specific to the BMF CCNIP, IRS has also developed four Servicewide performance and outcome measures for IRS's nonfiler activities overall. As of December 2009 IRS had data for its four performance measures for its individual nonfiler program including trend data going back to fiscal year 2005. At the time we finished our work, IRS did not have comparable information on business nonfilers it could use to identify trends, assess how well the new initiative is working, or decide whether adjustments needed to be made.

- *Voluntary filing rate.* The voluntary filing rate is defined as the total number of required returns filed on time divided by the estimated number of returns required to be filed. At the time we finished our work IRS had not estimated a voluntary filing rate for business nonfilers. As discussed earlier in this report, no data set for the population of all U.S. businesses exists that could be used to estimate the tax gap for businesses or the total number of business returns that should have been filed.

- *Percentage of returns secured.* This measure is calculated by dividing the total number of nonfiler returns secured during the fiscal year by the total number of nonfiler cases closed. IRS originally planned to develop management reports on business nonfiler cases comparable to the management reports it uses to calculate this measure for individual nonfiler cases. Developing the business reports, however, presented technical difficulties. At the time we finished our work IRS was planning to use BMF CCNIP management reports not yet developed as the data source.

- *Repeater rate.* Under the Servicewide definition established by the NFEAC, a repeat nonfiler is defined as a current-year nonfiler that was also a nonfiler in any year of a 2-year look-back period. IRS's automated systems do not track repeat nonfiling by businesses. IRS has identified recidivism as a significant problem among individual nonfilers but has no way to know if this is also a problem among businesses.[20] If it is, IRS will not be able to assess the effect of current and planned changes to its business nonfiler compliance activities on repeat business nonfiling due to a lack of baseline data.

- *Efficiency rate.* The efficiency rate is calculated by summing all individual and business nonfiling closed cases and dividing by the number of staff-years expended. IRS officials told us efficiency is calculated on a combined basis because IRS does not differentiate between individual and business cases when tracking staff time expended. IRS's Servicewide nonfiler efficiency measure does include data on business nonfilers, but without separate business and individual measures, IRS has no way to compare the relative efficiency of the two types of cases.

At the time we finished our work IRS officials told us they planned to put BMF measures on the agenda for the September 2010 NFEAC meeting. However, it is not clear whether the meeting will include setting a deadline for developing such measures.

[20] An internal IRS research report done in 2001 on business nonfilers found that about 28 percent of businesses identified as nonfilers had more than 1 nonfiler module and some had up to 20 nonfiler modules.

IRS Is Monitoring the Use of Selection Codes but Does Not Yet Have a Formal Plan to Evaluate Them

Selection codes are a key feature of the BMF CCNIP because they distill the business information that IRS has on a case into a prioritized code. Since IRS seeks to reduce the number of cases closed as "not liable to file a return," the design and priority order of the codes are important to program success. If selection codes do not accurately identify businesses with a greater potential for securing delinquent returns and generating more revenue, the proportion of unproductive cases may not decline.

IRS did not test or evaluate the selection codes prior to the beginning of the BMF CCNIP in April 2009. Rather, IRS developed the selection codes using input from those in the agency with knowledge of business nonfiler activity. According to those involved in the process, selection codes were developed through discussions among IRS staff working on business nonfiler programs and included representation from multiple IRS business operating divisions. However, IRS did not conduct a formal study or pilot test to aid in designing the selection codes.

Since BMF CCNIP implementation, IRS has been monitoring the selection codes including changes in the number of taxpayer responses to notices. According to IRS officials, BMF CCNIP issues are discussed at two annual meetings. One meeting concerns coordinating workflow for both business and individual nonfiler programs, and the other is a meeting of BMF CCNIP stakeholders where work plans are reviewed and any changes to the system including to the selection codes are discussed. IRS has made some changes to refine the selection codes but has not formally evaluated them. As a result, IRS does not know if the changes improved the codes, nor do they have a basis for knowing whether they now have an optimum set. A more formal and extensive evaluation could give IRS data to identify any need to change selection code priority, or create new or redefine existing selection codes. Our past work has shown that evaluations are beneficial in generating information to guide program decisions.[21] IRS's Performance Measures Plan for the program identifies many of the components of an evaluation including goals for the program and potential data sources to monitor it. However, this plan does not present a method for conducting an evaluation or a timeline for its completion.

[21]IRS recognized the importance of an evaluation plan by producing one for its State Reverse File Match Initiative (SRFMI) program. This evaluation plan was in response to our recommendation to develop such a plan. See GAO, *Tax Administration: IRS Needs to Strengthen Its Approach for Evaluating the SRFMI Data-Sharing Pilot Program*, GAO-09-45 (Washington, D.C.: Nov. 7, 2008).

IRS officials told us they plan to revisit the selection codes and evaluate the BMF CCNIP in the future, but they have no formal evaluation plan or timetable. They told us that it was too early to evaluate the BMF CCNIP due to the time needed for a case to go through all the stages of pursuit. According to the officials, the earliest date when complete information would be available to analyze the effectiveness of the BMF CCNIP would be 2011. Those directly involved with the BMF CCNIP said that choices of selection codes in weekly case selection were being made with an evaluation in mind, so they attempt to select cases for pursuit from a wide variety of selection codes. In our analysis of fiscal year 2009 management report data, we found that cases had been selected from across most selection codes. This practice may provide useful data but without a formal evaluation, IRS will not know how the selection codes are affecting the program outcomes.

Refinements to Closing Codes Could Provide More Information on Why Businesses That Did Not Owe a Return Were Identified as Potential Nonfilers

When a nonfiler case is closed, IRS collections staff use a two-digit closing code that in some instances provides information on why a case was closed. For some types of cases closed as not liable to file a return, the closing code may explain why. For example, a case can be closed as not liable to file for the period in question because the business was identified as a subsidiary and the parent company filed the return. A case may also be closed as not liable to file if IRS determines that little or no tax is due from the business. Each of these situations has a separate and distinct two-digit closing code. In contrast, there are other closing codes that do not specify why the case was closed as not liable to file. These types of closing codes specify which collections function closed the case but do not provide any additional information. Our analysis of IRS management data shows that of the cases closed as not liable to file in fiscal year 2009, 65 percent were assigned closing codes that do not indicate the reason the case was closed.

More detailed closing code information could be useful to IRS by providing information on business nonfiler cases that it currently lacks. IRS's closing codes do not specify many of the reasons that a case could be closed as not liable to file. For example, a business may no longer be operational but may have failed to indicate to IRS that its last return was a final return. IRS does not have closing codes for other types of situations, such as when a business has changed its structure but failed to notify IRS or where a business does not have employees for a given tax period but failed to indicate on its last filed employment tax return that it is a seasonal employer. Because there are no closing codes indicating these reasons for case closure, IRS does not know the extent to which these situations are a problem and it cannot begin to identify actions that might reduce their frequency.

Developing more detailed closing codes could provide data that would be valuable in program evaluation. Depending on results, the data might also lead to education and outreach activities targeted at reducing the number of identified business nonfilers. For example, better information on case closing decisions might identify a need to improve guidance or forms.

IRS Could Improve Business Nonfiler Case Closure Decisions through Additional Use of Information Returns and External Data

Selection Codes Can Help Verify Business Activity When Closing Cases

Under BMF CCNIP, information returns play an important role in selecting potential nonfiler cases for investigation because they are good indicators of business activity. Information returns also play an important role in making case closure decisions on whether a business is liable to file a return. The *Internal Revenue Manual* (IRM) requires that, before closing a case as not liable to file a return, IRS collection staff are to do a full compliance check including checking whether information returns and other IRS records indicate business activity. For example, where a business taxpayer claims to not be operational for the tax period under investigation, collections staff are to review information returns to determine if there was business activity. If this check of information returns showed that there was business activity, staff is not to close the case until more research is performed.

BMF CCNIP selection codes are concise indicators of what IRS knows about a business's activity including its information return income. For this reason, the codes have potential to be helpful to collections staff when closing cases. Selection codes are readily available on the computer screens that IRS collections staff use to research cases and record case closings. Selection codes can therefore be used to check taxpayers' claims that they do not owe a return. If the selection code indicates business activity, this could help guide IRS enforcement staff in doing the full compliance check. In December 2009 IRS updated the IRM to include a statement that staff should refer to the selection code to assist them in determining whether a taxpayer is liable to file a return. A 2008 tax examiner training manual also provided guidance on how to effectively use selection codes.

Our analysis of nonfiler cases that were selected for work prior to the implementation of BMF CCNIP and that were mostly closed in 2008 and 2009[22] suggests that full compliance checks may not have been done to the fullest extent possible, since cases with information return income were closed as not liable to file a return. As shown in table 2, 39,931 tax year 2007 partnership and corporation cases[23] with information return income totaling over $193 billion were closed as not liable to file returns.[24]

Table 2: Number of Partnership and Corporation Tax Year 2007 Nonfiler Cases Closed As Not Liable to File Returns

(dollars in billions)

Business type	Number of cases	Amount of information return income
Partnerships	19,592	$113.5
C corporations	16,018	65.3
S corporations	4,321	14.7
Total	**39,931**	**$193.5**

Source: GAO analysis of IRS data.

It is difficult to determine whether knowing that a business had information return income would have led to different case closure decisions. About 90 percent of the cases shown in table 2 were closed without any explanation.[25] Although these results in table 2 do not indicate that these cases were closed inaccurately, they do call into question the

[22]IRS data indicate that 96 percent of the cases were closed in 2008 and 2009. The remaining 4 percent of the cases were closed in 2007 and 2010.

[23]All reference to cases in this section relate to unique businesses.

[24]We eliminated all cases from our analysis that IRS closed as not liable to file a return because they were subsidiaries of other businesses.

[25]Another 7 percent (2,941 cases) of the cases were closed as not liable to file a return because there was little or no tax due.

extent to which IRS staff took into consideration information return income data when making decisions to close cases. While information return income does not indicate the amount of tax due, it does indicate business activity, meaning that some of these businesses may have been required to file returns and pay taxes.

Our observations shortly after BMF CCNIP implementation and prior to the IRM update at one of the five IRS service centers that process business nonfiler cases suggest selection codes were not being used in closing cases. Tax examiners we spoke with had mixed awareness of the BMF CCNIP and selection codes. Although the staff was able to view the codes, tax examiners we observed during our site visits did not use selection codes nor view information returns when making decisions to close cases.

With the December 2009 revisions to the IRM, tax examiners are instructed to use selection codes as indicators of business activity when doing their full compliance checks. However, in the past they were instructed to use information returns for these checks. Our analysis shows that cases were closed in spite of the fact that information returns showed business activity. To the extent that staff do not make full use of the potential of selection codes and information returns, opportunities may likely be missed to secure tax returns and collect revenue from business nonfilers.

Private Sector Data on Business Activity May be Useful in Deciding Whether Businesses Are Liable for Filing Delinquent Returns

As discussed earlier, information return data are good indicators of business activity, but not all payments for goods and services are subject to information return reporting and not all businesses receive information return income. According to IRS data, about 19 percent of its business nonfiler inventory had selection codes that reflect third-party information. This number should increase once information return requirements for reporting businesses credit card payments go into effect in 2012 and requirements for reporting service payments made to corporations go into effect in 2013. Even after these payments are reported to IRS, certain other payments made with cash or by check will not be subject to information reporting. However, there are a number of private sector companies that maintain business activity data, such as data on a business's gross sales and number of employees, which might help IRS identify business nonfilers and help it determine whether a business is required to file tax returns. While IRS does not use private sector data to help it determine whether a business should file a tax return, it does have contracts with private sector companies for locating taxpayers' assets and obtaining credit reports on taxpayers that can be used by its collection field staff during their investigations.[26]

To test whether private sector data on business activity could be useful for determining whether businesses are liable for filing tax returns, we matched tax year 2007 nonfiler cases that IRS closed as not liable to file returns with a calendar year 2007 Dun & Bradstreet (D&B) database of businesses located in California and Illinois. Our test results showed that there were a total of 40,223 cases in those two states that IRS closed as not liable to file returns where there was a match on name and address between IRS and D&B records.[27] Of the 40,223 cases, 9,740 were for corporation and partnership delinquent returns and the remaining 30,483 were for delinquent employment tax returns. Of the 9,740 partnership and corporation cases, 7,688 cases had either little or no information return income but, as shown in table 3, had D&B total sales of about $4.1 billion.[28]

Table 3: California and Illinois Partnership and Corporation Nonfiler Cases Closed as Not Liable to File in Tax Year 2007 with Gross Sales

(dollars in billions)

Business type	Number of active businesses	Total sales for active businesses
Partnerships	2,658	$1.3
C corporations	4,366	2.5
S corporations	664	0.4
Totals	**7,688**	**$4.1**

Source: GAO analysis of IRS and D&B data.

Since these 7,688 cases had little or no information return income, IRS would have had little if any business activity data on which to make decisions on whether the businesses were liable to file returns. Private sector data, such as the D&B sales data, could fill that void.

[26]According to Internal Revenue Manual section 5.1.18.4, IRS has a contract with Accurint for its national asset locator tool and a contract with Smart.Alx, which is a Web browser used to access credit reports.

[27]See appendix I for an explanation of the D&B data matching process.

[28]Of the 7,688 cases, 3,960 cases had information return income of less than $1,000 while the remaining 3,728 cases had no information return income.

Of the 30,483 employment tax cases that were closed as not liable to file employment (Form 941) and unemployment (Form 940) tax returns, 4,523 cases had employees according to D&B data. Table 4 shows that these 4,523 businesses had a total of 11,418 employees in calendar year 2007, which indicates that they may have been required to file employment tax returns.

Table 4: California and Illinois Employment Tax Cases Closed as Not Liable to File in Tax Year 2007 with Gross Sales

(dollars in billions)

Type of form	Number of businesses with employees	Total number of employees	Total sales for businesses with employees
941	3,015	7,836	$ 8.4
940	1,508	3,582	3.8
Totals	**4,523**	**11,418**	**$12.2**

Source: GAO analysis of IRS and D&B data.

Under BMF CCNIP, IRS identifies potential nonfilers when the Business Master File records for the businesses indicate that they have a requirement to file returns. If the BMF does not indicate a filing requirement, then a potential nonfiler case would not be developed. To determine whether businesses with no BMF filing requirements may be liable for filing returns, we matched business entities that had been established on IRS's Business Master File in 2006 that had no filing requirements to D&B calendar year 2007 records of businesses that had California and Illinois addresses. The results of the match showed that 39,920 cases matched the names and addresses on both the IRS and D&B records. Table 5 shows that 39,920 cases had total sales of $29.5 billion and 4,185 of the 39,920 cases had a total of 16,869 employees.

Table 5: California and Illinois Cases with No Filing Requirements Indicated in the BMF That Had Sales and Employees

(dollars in billions)

Type of case	Number of cases	Total sales	Number of employees
Cases without employees	35,735	$ 9.2	
Cases with employees	4,185	20.3	16,869
Totals	**39,920**	**$29.5**	**16,869**

Source: GAO analysis of IRS and D&B data.

These data indicate that the businesses were active in 2007 and that the businesses might have been liable for filing income tax or employment tax returns. Taxpayer contact would have to be made in order to determine whether the businesses were liable to file returns.

Federal Contract Data May Be Useful in Identifying Federal Contractors Who Owe Tax Returns

In addition to examining potential private sector data, we also examined the Central Contractor Registration (CCR) file, which contains self-reported revenue and employment data on businesses that register annually to be awarded federal contracts, to determine whether it could be used by IRS in its business nonfiler program. This database generally dealt with federal contracts so its usefulness would be limited to the subset of the total business nonfiler population that had registered for federal contract consideration.[29]

We matched the calendar year 2007 CCR file, which contained over 400,000 registrants nationwide, to the tax year 2007 partnership, corporation, and employment tax cases that were closed as not liable to file returns. This match showed that there were 3,589 entities on the CCR file with reported revenue that were closed as not liable to file partnership (1,210 cases) or corporation (2,379 cases) returns. The match also found that 10,263 entities on the CCR file reported that they had employees that were closed as not liable to file either Forms 941 (8,694 cases) or Forms 940 (1,569 cases).

The above data show that there are a number of federal contractors with income that IRS closed as not liable to file returns. As noted earlier, in many cases IRS's records do not indicate the specific reason for closing a nonfiler case; therefore, we do not know why these cases were closed when the CCR data indicate that they may have been required to file returns because they had indications of business activity.

IRS does not give a high priority to potential business nonfilers that receive federal contracts when it selects business nonfiler cases for review but does so for federal workers and retirees who fail to file tax returns under its Federal Employee/Retiree Delinquency Initiative (FERDI) program. This program was developed in 1993 by IRS to promote federal tax compliance among current and retired federal employees. FERDI

[29]The CCR also contains data on federal assistance awards, which include grants, cooperative agreements, and other forms of federal assistance.

cases are given a specific priority selection code and are subject to the full range of compliance treatments, including return delinquency notices and field investigations. According to IRS data, in fiscal year 2009, IRS closed over 100,000 FERDI cases.

IRS recognizes that businesses receiving federal contracts should be identified and that appropriate and timely actions should be taken to ensure they remain in full compliance with federal tax laws.[30] IRS also has delinquent return procedures that address federal contractors. IRS has special procedures for investigating federal contractors who have been or will be awarded a contract by the IRS and who owe both outstanding taxes and tax returns. These procedures do not apply to federal contractors who only have unfiled returns. Also, according to IRS, during field return delinquency investigations, revenue officers are instructed to determine on initial contact with all taxpayers if the taxpayer is a federal contractor and, if so, to take prompt action to secure any delinquent business returns including their delinquent taxes.

Also, unlike federal employees and retirees covered by the FERDI program, federal contractor cases do not have a specific nonfiler selection code, which could give them a priority ranking at the beginning of the investigation process. Currently, IRS has an indicator on its Business Master File that identifies businesses that have federal contracts, but it is not used to prioritize federal contractor nonfiler cases. The source of the BMF federal contractor indicator is Form 8596 (Information Return for Federal Contracts), which certain federal executive agencies are required to file quarterly to report information about persons with whom they have entered into contracts.[31]

Since IRS already has a federal contractor indicator on its Master File records, it may be able to cost-effectively develop a specific nonfiler

[30]Federal contractors that owe delinquent taxes currently receive priority treatment. Under the Federal Payment Levy Program (FPLP) businesses and individuals who receive federal payments such as certain Social Security benefits, federal wages, and federal contract payments are subject to a continuous levy of up to 15 percent of individual and recurring specified payments. The American Jobs Creation Act of 2004 amended IRS's continuous levy authority by providing for a 100 percent levy on specified federal contractor/vendor payments.

[31]For tax year 2008, IRS processed 116,148 Forms 8596 for 102,248 taxpayer entities that had a valid EIN.

selection code that would give these cases a higher priority in its nonfiler program.

Conclusions

Identifying and pursuing nonfilers including businesses is a key part of IRS's enforcement efforts. Absent a robust nonfiler program, compliant taxpayers will not have confidence that others are paying their fair share. IRS has faced several challenges in its business nonfiler program. IRS generally identifies more potential nonfilers than it can thoroughly investigate, and many of those it does investigate turn out not to owe the return IRS expects based on its records. Our analyses suggest IRS cannot be sure these types of cases are all being closed correctly.

IRS has significantly improved its business nonfiler efforts by developing and implementing the BMF CCNIP. This initiative gives IRS for the first time a way to set priorities among its voluminous inventory by making use of information return and other IRS data to predict the likelihood that IRS will secure additional returns and revenue. This initiative should help IRS choose cases to work, but without an estimate of the business nonfiler tax gap, IRS does not have a data-driven basis for allocating resources to its business nonfiler efforts.

While IRS has made good progress in implementing BMF CCNIP, it has not calculated the performance measures or planned the evaluations it would need to assess success. IRS also has little data on why it identifies millions of potential business nonfilers only to find that many of them do not owe IRS the return IRS is expecting based on its records. Absent better information on cause, IRS may continue to expend resources on too many unproductive cases, leading to unnecessary taxpayer burden. Until and unless IRS has better information, it will not be able to measure its success or identify the best ways to continue to move in the right direction.

While IRS is gathering data needed to manage the program, it can also explore opportunities to build on what it has already achieved. IRS could leverage the information in the BMF CCNIP selection codes by using them to help verify taxpayers' claims that they do not owe a return because they have gone out of business. IRS could also explore adding non-IRS data to the BMF CCNIP. Private sector and federal contractor data on business activity would give IRS more third-party information and enlarge the capacity of the BMF CCNIP to identify active businesses, thereby potentially leading to fewer cases being closed as not liable to file a return.

Recommendations for Executive Action

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

Understanding the Scope of the Business Nonfiler Population

- Estimate the magnitude of business nonfiling among businesses registered with IRS, using data from its operational files to select cases for further investigation. Based on the results of this work IRS should develop a tax gap estimate for the impact of business nonfiling insofar as doing so is cost-effective.

Monitoring the Performance of Business Nonfiler Activities

- Set a deadline for developing data that can be used to measure the performance of the BMF CCNIP and its business nonfiler compliance activities overall.

- Develop a separate efficiency measure for business nonfilers insofar as doing so is cost-effective.

- Develop an evaluation plan for the BMF CCNIP selection codes, including both an initial evaluation and an ongoing monitoring plan, and conduct an evaluation based on this plan. Results from the study and the ongoing monitoring could be used to refine the selection codes to improve the effectiveness of the program.

Identifying Additional Actions to Help Achieve the Goal of Fewer Unproductive Cases

- Add closing codes that would better indicate all known causes for “not liable to file” determinations and use this information to analyze causes of unproductive cases and use them as appropriate to identify any actions IRS could take either administratively or through education and outreach that could reduce the number of business nonfiler cases where the filing requirement in IRS’s records is not applicable.

Ensuring That IRS Does Not Inappropriately Close Cases as Not Liable to File Returns

- Reinforce to collections staff the need to check for business activity using information return data and selection codes.

- Study the feasibility and cost-effectiveness of using private sector business activity data and federal contract data to make a determination of whether federal contractors and other businesses are liable for filing tax returns.

Ensuring Federal Contractors Comply with Filing Requirements

- Establish a process similar to the FERDI program for federal workers and retirees that will give a high priority to businesses identified as potential nonfilers that have federal contracts.

Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of Internal Revenue. We received written comments from the Deputy Commissioner which are reprinted in appendix IV. IRS agreed that identifying and pursuing active business nonfilers is key to enforcement efforts and acknowledged that our recommendations could assist these efforts. IRS agreed with four of our eight recommendations and indicated as discussed below some steps it would take to address the other four.

With respect to our recommendation that IRS should estimate the magnitude of business nonfiling by selecting cases from its operational files for further investigation, IRS agreed to collect and report additional data on the number of delinquent business returns identified by its operational programs and the dollars assessed. IRS indicated that such data may overstate the extent of nonfiling because they would include cases such as businesses that filed returns under a parent entity. The intent of our recommendation, however, was to have IRS develop an estimate of the number of businesses that were actually liable for filing returns, which would exclude businesses that were not liable to file returns. It is not clear from IRS's response whether it intends to do the study we recommended or if IRS plans to report only the results currently available from its business nonfiler program. Our recommendation was that IRS draw a sample of potential business nonfilers and thoroughly investigate those cases to estimate the number of actual business nonfilers in IRS's business nonfiler inventory.

With respect to our recommendation that IRS develop an evaluation plan for the BMF CCNIP selection codes, IRS identified monitoring activities for its new BMF CCNIP report as well as additional information that could be used to evaluate the program. IRS also said that data should not be studied until they are complete and available, which IRS estimates to be by the end of fiscal year 2011. We acknowledged many of IRS's monitoring activities in our report but these do not constitute an evaluation plan that would identify a method for conducting an evaluation and a timeline for its completion. We recognize that time will be needed for cases to complete the collections process and did not propose a timeline for IRS to complete its evaluation. Our recommendation addressed the need for IRS to develop an evaluation plan for the BMF CCNIP selection codes, including both an initial evaluation and an ongoing monitoring plan, and conduct a study based on this plan.

With respect to our recommendation that IRS should study the feasibility and cost-effectiveness of using private sector business activity data and federal contract data, IRS agreed to evaluate the effectiveness of data mining using the Central Contractor Registration database but did not agree to study the feasibility of using private sector data. IRS stated that a study initiated in fiscal year 2009—which IRS did not provide to us during the course of our audit work—concluded that it would be difficult to quantify benefits because there is not an automated way to effectively match Taxpayer Identification Numbers to purchased lists of business names. IRS's response, however, does not address our analysis illustrating the use of private sector data in our report, which showed that using such data was not only possible but potentially beneficial. While we cannot determine the revenue implications of these cases including whether potential revenue would exceed IRS's threshold, our analysis shows that private data can provide information not now available to IRS on the business activity of potential nonfilers. For this reason, we continue to recommend that IRS further explore the feasibility and cost-effectiveness of private sector business activity data.

With respect to our recommendation that IRS establish a process for federal contractors similar to the process established by its FERDI program for individuals, IRS agreed to explore the feasibility of establishing a system for prioritizing and routing federal contractor nonfiler cases through its current Inventory Delivery System. IRS also stated that it is working on further actions—including implementing legislative changes—that will identify noncompliant federal contractors. IRS stated that a federal contractor with an unfiled employment tax return is a high priority in the case selection process. While employment tax cases are prioritized in IRS's case selection process, federal contractors do not receive higher priority than nonfederal contractors because there is no selection code specifically aimed at federal contractors. Since IRS already has a federal contractor indicator on its Master File records, our recommendation was based on the assumption that IRS could cost effectively develop a specific nonfiler selection code that would give these cases a higher priority.

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

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

James R. White
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

The objectives of this report were to assess (1) the data challenges of estimating the business nonfiler tax gap, (2) how recent program changes in the Internal Revenue Service's (IRS) processes and procedures have affected its capacity to identify and pursue business nonfilers, and (3) what opportunities exist for IRS to improve its use of third-party information returns or other sources to identify and pursue business nonfilers.

To assess the data challenges of estimating the business nonfiler tax gap, we reviewed IRS documents and prior GAO and Treasury Inspector General for Tax Administration (TIGTA) reports that dealt with tax gap measurement and IRS's National Research Program, which develops data for use in making estimates of the tax gap relating to tax reporting noncompliance. We analyzed Business Master File Case Creation Nonfiler Identification Process (BMF CCNIP) inventory data to determine the number of potential business nonfilers IRS identifies and analyzed IRS's fiscal year 2009 Collection Activity Reports to determine the number of business nonfiler cases IRS closed as not liable to file returns. We interviewed IRS research officials from the Small Business/Self-Employed (SBSE) and the Research, Analysis, and Statistics (RAS) Divisions on the types of data that would be needed to develop a business nonfiler tax gap estimate and the problems associated with obtaining such data.

To assess how recent program changes in IRS's processes and procedures have affected its capacity to identify and pursue business nonfilers, we reviewed program documents pertaining to BMF CCNIP. These documents dealt with the cost and benefits of the program; program evaluation and performance measurement processes; and procedures for identifying, prioritizing, selecting, working, and closing business nonfiler cases. We also reviewed *Internal Revenue Manual* (IRM) sections dealing with handling taxpayer responses to delinquent return notices and procedures for closing business nonfiler cases and IRS documents on its Nonfiler Strategy and its implementation. We interviewed IRS officials from SBSE to understand the various operational features and processes associated with the BMF CCNIP. To understand how IRS handles responses to delinquent return notices from businesses, we observed IRS's collections functions at IRS's Philadelphia service center.

To assess what opportunities exist for IRS to improve its use of third-party information returns or other sources to identify and pursue business nonfilers, we identified non-IRS data sources—including government contractor data and private sector data—that could have information on business nonfilers and assessed the potential of this information to help

IRS better identify and pursue business nonfilers. To test whether information return income could be useful in making case closure decisions under BMF CCNIP, we matched IRS's calendar year 2007 Aggregated Information Return (AIR) file, which is used in BMF CCNIP and contained summaries of information returns that were received by IRS, to IRS's Nonfiler Measurement file that contained data on all tax year 2007 cases that were closed as not liable to file partnership (Form 1065) and corporation (Form 1120) returns. We limited our analysis to tax year 2007 cases that had information return income of $1,000 or more. According to IRS officials, tax year 2007 business nonfiler cases were selected prior to the implementation of BMF CCNIP. Our analysis showed that about 96 percent of the cases were closed in 2008 and 2009 while the remaining 4 percent were closed in 2007 and 2010. In doing this match we eliminated all cases that were closed because they were subsidiaries of other businesses and thus would not have been required to file returns under their Employer Identification Numbers (EIN). We did not follow up on any of the closed cases to determine whether using the information return income data would have resulted in a closure different than not liable to file a return. To determine whether these businesses would have been liable to file returns would have required IRS to reinvestigate the cases. To determine whether the data in IRS's Nonfiler Measurement file were of sufficient reliability for our analysis, we reviewed the program documentation associated with the file and discussed the various data elements with the IRS staff responsible for the file. As a result of our review and discussions, we determined that the data in this file were of sufficient reliability to be used in our analysis.

To test whether private sector data on business activity could be useful for determining whether businesses may be required to file partnership, corporation, and employment tax returns, we matched IRS's tax year 2007 Nonfiler Measurement file of nonfiler cases that IRS closed as not liable to file returns to a Dun and Bradstreet (D&B) file of businesses located in California and Illinois. We judgmentally selected these two states to get a geographic mix of states that had sufficient cases that were closed as not liable to file tax year 2007 returns to test the viability of using private sector data. The D&B file contained various data on business activity including name, address, sales, and employment information. Combined, California and Illinois had 130,336 or about 14.3 percent of the 914,505 corporations, partnerships, and employment tax cases that were closed as not liable to file tax year 2007 returns. Since the D&B files did not include the businesses' EINs, the match was made on the businesses' name and address, which included the street address, state, and ZIP code. To make the name and address matches, we used D&B's onsite matching software program, which can be used to associate records with differences in name and addresses to a particular entity. Each match is assigned a confidence code from 0 to 10, with 10 being the highest confidence score and 0 the lowest or no match. According to D&B documents, scores of 8 to 10 are considered high-quality matches and were the matches we used for our analysis. Our match of the 130,336 California and Illinois cases resulted in 40,223 high-quality matches (9,740 corporations and partnerships and 30,483 employment tax cases). Of the 9,740 partnership and corporation cases, 7,688 cases had either little or no information return income. Of the 30,483 employment tax cases, 4,523 had employees.

Also, to determine whether private sector data could be useful in identifying active businesses that IRS had not identified as nonfilers, we matched the D&B data files of California and Illinois businesses to a Business Master File (BMF) extract of 176,061 entities on the BMF that had been established in calendar year 2006 but had no filing requirements as of September 2009, which was when IRS produced the extract for us. As a data reliability check on this no filing requirement extract, both GAO and IRS staff spot checked selected output from this extract to IRS's National Accounts Profile (NAP) file, which contains all valid taxpayer names, addresses, taxpayer identification numbers, and filing requirements. These checks showed that the names were valid and that the businesses did not have any filing requirements. The match of D&B data to the no filing requirement extract produced 39,920 cases that were considered to be high-quality matches (i.e., they had confidence scores of 8 to 10) and were the ones we used for our analysis. Since D&B is a commercial business, we were not able to validate the sales and employment data contained in the file. However, according to data D&B officials provided to us, D&B collects its data through direct investigations, such as phone calls to businesses, and reviews of trade records on payment and financial data, public records, and government registries, and Web sources and directories. Also, since D&B data are used by various federal agencies, we determined that the data were of sufficient reliability to be used in our analysis.

To test whether other federal data sources could be useful for identifying business nonfilers, we analyzed the 2007 Central Contractor Registration (CCR) file, which we received from the General Services Administration, which contains data on businesses that must register at least annually to compete for federal contracts. We tested this file because it contains various entity data such as name, address, and EIN, which could be readily matched to IRS's records. Businesses that want to vie for federal contracts must submit a valid EIN for inclusion onto the CCR. The EINs are validated against IRS's records before they are included in the CCR. Also, the CCR file contains various self-reported data on business activity data, such as total revenue and number of employees for each business, which could be useful for making decisions on whether a business would be required to file returns. We matched the calendar year 2007 CCR file, which consisted of 441,467 records, to IRS's tax year 2007 Nonfiler Measurement file of cases that were closed as not liable to file returns to determine whether CCR data would identify potential federal contractors that had business activity data that would indicate that they may have been required to file returns. The match identified 3,589 entities on the CCR file with reported revenue that were closed as not liable to file partnership (1,210 cases) or corporation (2,379 cases) returns. The match also found that 10,263 entities on the CCR file reported that they had employees that were closed as not liable to file either Form 941 (8,694 cases) or Form 940 (1,569 cases). We did not verify the accuracy of the data on the CCR file because these data are self-reported by businesses entering the data onto the CCR database. However, since the EINs on the CCR are validated to IRS's records, we determined that the CCR data we used for our analysis were sufficiently reliable to use in our assessment.

We conducted this performance audit from March 2009 through August 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Additional Information on Businesses' Filing Requirements

Form	Who should File	Filing timeline	Extensions
940: Employer's Annual Federal Unemployment (FUTA) Tax Return	Businesses with one or more employees that paid at least $1,500 in wages in a calendar quarter and businesses that had one or more employees for at least some part of a day in any 20 or more different weeks during the calendar year must file Form 940 to report Federal Unemployment Tax Act tax. Household employers that paid at least $1,000 in wages in a calendar quarter must file Form 940.	Annually. Return due on February 1st after the end of the calendar year. Those who made full payments prior to filing may file by February 10.	An extension may be requested via letter. Extensions are not to exceed 90 days.
941: Employer's Quarterly Federal Employment Tax Return	Businesses with one or more employees file Form 941 to report information on employees including wages paid, federal income tax withheld, and Social Security and Medicare taxes paid by employers and employees.	Quarterly. Return due the last day of the month following the end of the quarter.	Extension requests are not allowed. Form 941 has a 10-day extended due date if 100% of the tax amount has been deposited on time.
1120: U.S. Corporation Income Tax Return	Domestic corporations—unless corporation meets the criteria and has elected to be treated as an S corporation. The return is used to report income, gains, losses, deductions, credits, and to figure the income tax liability of a corporation.	Annually. Return due by the 15th day of the third month following end of corporation's tax year. For example, if tax year is equivalent to calendar year, filing would be due March 15.	Business can file IRS Form 7004 to be granted a 6-month extension.
1120S: U.S. Income Tax Return for S Corporation	S corporations. An eligible domestic corporation can avoid double taxation (once to the shareholders and again to the corporation) by electing to be treated as an S corporation.	Annually. Return due by the 15th day of the third month following end of corporation's tax year. For example, if tax year is equivalent to calendar year, filing would be due March 15.	Business can file IRS Form 7004 to be granted a 6-month extension.
1065: U.S. Return of Partnership Income	Partnerships. A partnership is the relationship existing between two or more persons who join to carry on a trade or business. A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it generally "passes through" any profits or losses to its partners.	Annually. Return and Schedule K-1 information returns (which report income shares to partners) due on the 15th day of the 4th month following the close of its tax year.	Business can file IRS Form 7004 to be granted a 5-month extension.

Source: GAO analysis of IRS documents.

When a business changes its structure or hires employees, the business is required to notify IRS and in some cases may need a new EIN.

- A business is required to notify IRS if its structure changes, for example if it restructures as an S corporation, a partnership, or a subsidiary of another company.[1] A subsidiary that elects to have its income, losses, and deductions included in the parent business's consolidated income tax return is not required to file an annual return.

- A business that ceases to operate is expected to inform IRS including by sending a letter and checking a "final return" box on its income tax return.[2] A business is also required to notify IRS if it stops paying wages or is a seasonal employer.

A business that fails to notify IRS of a change affecting its filing requirement risks being identified as a potential nonfiler by IRS when it matches its records against returns filed.

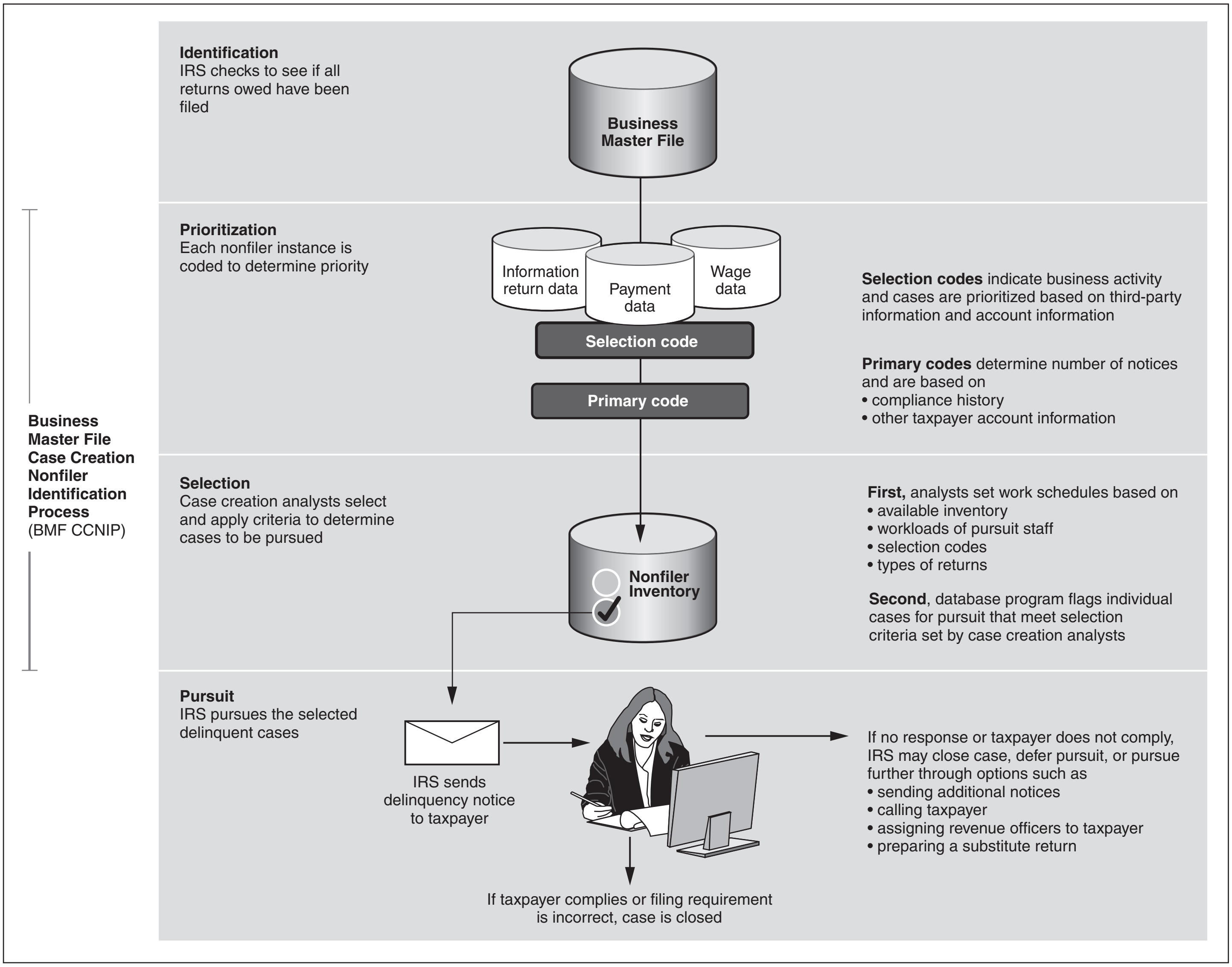
[1]Where a subsidiary elects to have its income, losses, and deductions included in the parent business's consolidated income tax return, Form 1122 must be completed by the subsidiary and filed with the parent business's income tax return.

[2]A corporation electing to be taxed as an S corporation notifies IRS by filing a Form 2553. For businesses ceasing to operate, IRS's Web site has a checklist of actions to be taken, including writing IRS a letter. See http://www.irs.gov/businesses/small/article/0,,id=98703,00.html and http://www.irs.gov/businesses/small/article/0,,id=177073,00.html, downloaded on May 7, 2010. IRS's Web site and, in some cases, the tax forms themselves, provide information on how and what types of changes businesses must communicate to IRS. Once IRS has received notification of a change, it can update its record of the business's filing requirement on its Business Master File (BMF) as needed.

Appendix III: How IRS Identifies and Pursues Business Nonfilers

IRS identifies potential business nonfilers primarily using its return delinquency check process. Under its new Business Master File Case Creation Nonfiler Identification Process (BMF CCNIP), IRS prioritizes which of these potential business nonfilers will be pursued using information return and historical account data in IRS's records on the business entity. Once a case has been selected for pursuit, IRS mails the taxpayer a notice of delinquency. If IRS is not successful in resolving a case through this taxpayer correspondence, the case may proceed to one of IRS's collections functions. Figure 1 shows IRS's process for business nonfiler cases through the notice stage.

Figure 1: Business Nonfiler Cases Can Go through a Multistage Process from Identification to Pursuit



Source: GAO analysis of IRS information.

Identification

IRS's return delinquency program checks the filing requirement of each business against the returns filed by that business for a given tax period. This process is completed every week for all return types. If IRS identifies a business that has not filed a return for a filing requirement on IRS's BMF a specified number of weeks after the due date for the return including any extensions, a delinquency module is created for the missing return. Previously, the program identified as delinquent only those businesses that had filed in the past and then ceased filing or had made payments to IRS. However, since the introduction of the BMF CCNIP, IRS now includes some entities that have an income tax filing requirement but have never filed.

Prioritization

The BMF CCNIP has changed IRS's business nonfiler activities by using several types of IRS taxpayer data provided by businesses and about businesses to create indicators of business activity and prioritize these businesses for pursuit based on the likelihood of generating revenue. The goal of the BMF CCNIP is for IRS to pursue more productive cases by reducing the number of these cases it pursues where the business is not liable to file a return, e.g., because it is no longer active. In this way, IRS aims to better use its limited resources for pursuing business nonfilers.

Selection codes are the feature of the BMF CCNIP that assists IRS in prioritizing the inventory and determining which cases should be pursued. Specifically, selection codes are used to determine which cases are sent to IRS's campuses, which are the locations of the IRS service centers that handle initial pursuit activities. The campuses will send a taxpayer a notice of delinquency. This notice details the delinquent tax form and period and requests the taxpayer file the form.

The third-party information IRS uses to assign the selection codes comes from three sources:

- The **Aggregated Information Return** (AIR) file contains data from information return forms such as the Form 1099 series. This file is updated annually.
- The **Payer Master File** (PMF) contains information on those who file these information returns and make payments documented by the information returns.
- The **Combined Annual Wage Reporting** (CAWR) file contains information on business payments for employment taxes including Social Security and Medicare.

Selection codes range from 01 to 99 and represent IRS's priority for working cases.[1] Cases with a lower number selection code have a higher priority. Each code indicates characteristics of the information IRS has about the case. Examples of selection codes are "high dollar credits," "high information return income without broker sales," and "broker sales." Selection codes 97 through 99—the lowest priority codes—are typically for those cases with no indication of business activity.[2]

In addition to a selection code, a primary code[3] is also assigned to each case. These codes indicate the number of delinquency notices a case should receive once it has been selected and whether the case will be pursued further after the notice stage. Primary codes are determined based upon compliance history and the type of return.

Once these codes have been applied to cases,[4] the cases are placed in the nonfiler inventory. The inventory includes all identified business nonfiler delinquencies, both cases that have and have not been forwarded to IRS's collections functions for collection. As of the end of calendar year 2009, the nonfiler inventory had 46.6 million cases in it. All cases will remain on the nonfiler inventory for 6 years.

Selection

Case creation analysts—a new position created with the BMF CCNIP—decide on a weekly basis the number of cases to move from the nonfiler inventory for pursuit. Using the selection codes, case creation analysts are able to select not only the number of cases sent for further processing, but the selection code and return type as well. They are also able to direct the

[1]There is also a selection code of 00, which indicates cases that are "on hold." An example of such a case would be one that is being investigated as a criminal case.

[2]Certain selection codes apply only to particular return types.

[3]Primary codes are assigned to a case by the BMF CCNIP. However, these codes existed prior to the creation of BMF CCNIP and were assigned by the Business Master File.

[4]Type Indicator Codes (TIC)—added with the establishment of the BMF CCNIP—are also applied to cases before they are placed on the nonfiler inventory. TIC codes may be used to accelerate a case directly to the collections function. For example, taxpayers that have filed an extension but still have not filed by the extension deadline receive an accelerated TIC code because they have shown the intention to file when they asked for the extension. While every case is assigned a TIC code, most cases receive one that directs a case through the normal process of the nonfiler inventory. Currently, accelerated TIC codes are rarely used.

cases to one of five specific campuses.[5] Case creation analysts we spoke with said they select cases to move to collections based upon several factors including: the makeup of the inventory, selection codes, return type, and input from the collection functions at the IRS campuses on their workloads. IRS officials told us that one goal is to assure coverage across the different return types; another goal is to match cases selected with the capacity of campuses to send the notices. Information from the BMF CCNIP, such as the number of cases in the inventory and selection codes used, is contained in management reports. IRS said that the information in these reports is used by case creation analysts to make selection decisions.[6]

Pursuit

Notice Stage

At the first stage of the collections process, the notice stage, IRS first attempts taxpayer contact by mailing a delinquency notice. This notice informs the taxpayer of the identified delinquency, and provides information on how to respond to the delinquency. According to IRS data, in fiscal year 2009, IRS issued 2.6 million initial notices to business nonfiler cases.[7]

If a response (either a return or an explanation of why no return is due) is received from the taxpayer, the response is forwarded to a tax examiner in IRS's Compliance Services Collection Operations (CSCO) function. The tax examiner is responsible for verifying that a return filed matches the filing requirement or that the response otherwise justifies closure of the case. In some cases where taxpayers claim that they do not owe a return, tax examiners are required to perform a full compliance check, which is a method to verify the taxpayer's response and to ensure that there are no other outstanding modules. If the taxpayer response does not resolve the

[5] The campuses that process business nonfiler cases are Brookhaven (NY), Cincinnati (OH), Memphis (TN), Ogden (UT), and Philadelphia (PA).

[6] Case creation analysts also use a "default schedule" to guide their decisions. The default schedule is created annually and provides a guide for case creation analysts by setting weekly values for each of the variables that the analysts must choose. IRS officials told us that the default schedule is referred to on a weekly basis, but selections often vary from those proposed in the schedule.

[7] When a case is in notice stage, TDI Analysis—a computer program—periodically reexamines information on the case to determine whether a case will receive the second notice, be closed, or be directed onward. TDI Analysis also updates information on the Business Master File.

delinquency, tax examiners will sometimes contact the taxpayer to discuss the matter.

The primary code assigned to the case determines what happens next if the taxpayer does not respond. Business nonfiler cases generally receive a Primary Code B, A, or X.

- If the case received a Primary Code B, it will not be pursued beyond the first notice. Cases receive a Primary Code B when they do not meet the criteria for any other primary code. Primary Code B cases, also known as "suppressed" cases, generally fall below a certain threshold for the tax liability from the entity's last return.

- If the case received a Primary Code A, it will receive another notice before being forwarded for further pursuit.

- Primary Code X cases receive one notice and if IRS receives no response, the case is forwarded for further pursuit after 6 weeks. Primary Code X is reserved for employment tax cases where the tax due by the business for the previous year was above a certain threshold.

In some instances, if a delinquent module is identified and the taxpayer already has other modules further along in the pursuit process, the newly identified delinquent module is moved after receiving the first notice to the collection function with other modules from the same business; this process is called "association."

Post-Notice Stage Collections Functions

If the notice or notices do not elicit a response from the taxpayer, IRS guidelines and a routing program are used to determine the next destination for the case.

- If a case meets criteria established in the *Internal Revenue Manual* (IRM), it will go directly to the destination prescribed. One example of the criteria for a case to use the rules is where the last return amount—the tax liability from the last return—is above a certain threshold.

- Alternatively, a case is routed further by the Inventory Delivery System (IDS). IDS governs movement to, from, and between IRS pursuit functions. The system makes these determinations based on risk and business rules. These rules include a set of criteria used to score a case based on the following factors: age of case, balance due, number of modules for the entity, the type of return, credit balances, the tax due from the prior year's tax return, and prior year net tax. In addition to these risk scores, IDS also uses predictive models to generate probability scores. These models predict the likelihood of certain outcomes, including securing a return and securing the full amount of money due.

IDS moves cases to one of the following functions after a predetermined number of weeks from when the notice was sent:

- The Automated Collection System (ACS) is responsible for making telephone contact with taxpayers who have not responded to notices. In some cases, the call site operators who make this contact must research contact information for the delinquent taxpayer.

- The automated 6020(b) (a6020(b)) program can be used to prepare a substitute return for business nonfilers without the intervention of ACS or the field. This program is limited to employment tax cases with an amount below a certain threshold.[8] This program automatically prepares a return for certain businesses that have not filed based on information that IRS has. The automatically prepared return is then sent to the entity, which has the ability to respond with its own return if it does not accept the prepared return. If no response is received, IRS has the authority to create an assessment for all taxes and penalties due.

- The Queue is a holding area for cases. Cases can move from the Queue to the field. In certain circumstances, cases have been routed from the Queue to a6020(b) or CSCO.

- Revenue officers in the Collection Field Function (the field) make in-person contact with delinquent taxpayers in efforts to secure returns.

In addition, if IDS criteria determine that the case is of low enough priority, IDS can close the case.

Generally, cases that receive further pursuit beyond notice stage first go to ACS. If ACS has not been successful in closing a case after 13 weeks or

[8]Revenue officers and some call-site operators have the ability to use the 6020(b) program to prepare a return for business nonfilers as well.

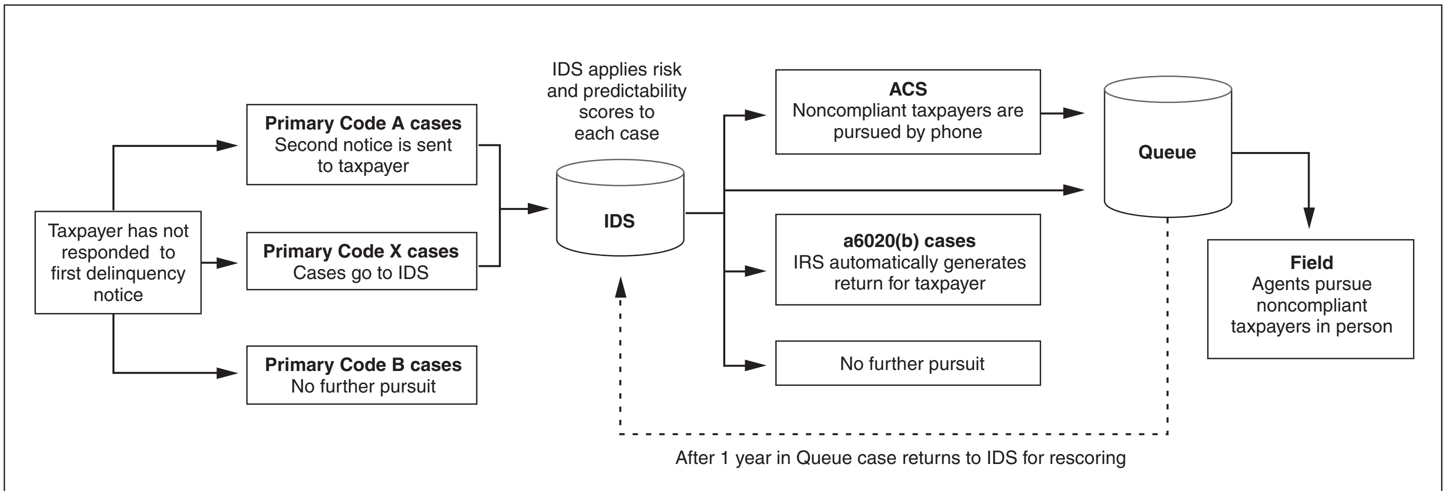
does not send it to a6020(b), the case may then be moved to the Queue, where it will be available for the field to pursue further.

When a case goes to the Queue, it is assigned a level of risk and a probability score. The risk level—high, medium, or low—takes into account dollar amount, age of case, and type of return. Cases are assigned to one of four priority groups in the Queue based upon these scores. Those cases that are “high risk” and have a high probability score—indicating a greater likelihood of collecting revenue—become the highest priority cases. The other groups—high risk, medium risk, and low risk—are based solely on risk scores. When group managers need cases for the field, they review cases based on priority for potential selection to the field. If a case remains in the Queue for 52 weeks, it is reevaluated by IDS. Based on this evaluation, it can be sent back to ACS, remain in the Queue, or—if the case has become a low-risk case based on the reevaluation—the case can be closed.[9]

Figure 2 provides an overview of the coding systems and automated systems that govern the path of a business nonfiler case that proceeds beyond the notice stage into IRS’s collections functions.

[9]Cases can also be sent to CSCO or a6020(b) from the Queue, but these cases are relatively less frequent.

Figure 2: Cases Selected for Pursuit Can Take Multiple Paths after Receiving First Notice



Source: GAO analysis of IRS information.

Cases that leave the Queue for pursuit are generally high-dollar cases, cases involving more than one delinquent return,[10] and cases involving both nonfiling of returns and nonpayment of taxes owed. Revenue officers have multiple methods of enforcement they can use to secure returns and payments, including preparing substitute returns using IRS's authority to do so under Internal Revenue Code 6020(b) and legal options, such as injunctions or summons.

[10]When employment tax delinquencies continue to accumulate after the taxpayer has been assigned to the field for pursuit, IRS considers the case to be "pyramiding." IRM Section 5.7.8 describes the pyramiding cases and the role of the field in pursuing them.

Appendix IV: Comments from the Internal Revenue Service

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

DEPUTY COMMISSIONER

August 25 2010

Mr. James R. White
Director, Tax Issues
U. S. Government Accountability Office
Washington, DC 20548

Dear Mr. White:

Thank you for the opportunity to review your draft report entitled, "Tax Gap: IRS Has Modernized Its Business Nonfiler Program But Could Benefit From More Evaluation and Use of Third-Party Data" (GAO-10-950).

We recognize that assigning the best possible nonfiler inventory for investigation will result in the best use of our resources. We agree that identifying and pursuing business nonfilers who remain in business is a key component of our enforcement efforts and that your recommendations may assist us in those efforts.

In July 2008, the IRS adopted Servicewide Nonfiler Performance and Outcome Measures. These strategic measures gauge our overall performance in delivering the nonfiler mission and goals. Such measures describe the intended result of carrying out a program and emphasize outcome over process. The IRS will soon begin exploring new business nonfiler measures pursuant to your recommendation.

Your report acknowledges our new potential business nonfiler filter, the Business Master File Case Creation Nonfiler Identification Process (BMF CCNIP). We regularly evaluate and monitor the BMF CCNIP inventory and evaluate possible enhancements to the process. Through BMF CCNIP, a federal contractor with an unfiled employment tax return is a high priority in our case selection process. In addition to BMF CCNIP, there are actions implementing legislative changes that will filter out or identify non-compliant federal contractors (e.g., Enhancing Payment Accuracy Through a "Do Not Pay List" and Internal Revenue Code section 3402(t)(1) "Three (3) percent withholding"). These actions implementing legislative changes, along with other business processes will assist the IRS in protecting the integrity of the tax system and addressing federal contractors that do not file required returns.

The enclosed response addresses each recommendation separately.

If you have any questions, please contact me, or members of your staff may contact Nikole Flax, Assistant Deputy Commissioner for Services and Enforcement, at (202) 622-6860.

Sincerely,

Steven T. Miller

Enclosure

Enclosure

GAO Recommendations and IRS Responses to GAO Draft Report
Tax Gap: IRS Has Modernized Its Business
Nonfiler Program But Could Benefit From More
Evaluation and Use of Third-Party Data
GAO-10-950

Recommendation 1:
Estimate the magnitude of business nonfiling among businesses registered with IRS, using data from its operational files to select cases for further investigation. Based on the results of this work IRS should develop a tax gap estimate for the impact of business nonfiling insofar as doing so is cost-effective.

Comment:
The IRS will report the number of delinquent business returns identified by operational programs. However, this estimate may overstate the extent of nonfiling if a missing return is associated with a corporation that is defunct, has changed its name, changed its form of organization (e.g., from a partnership or C corporation to an S corporation), filed under a parent entity, filed under a different identification number, or merged with another entity. The IRS will report the dollars assessed on delinquent corporation and employment tax returns, but these amounts are not synonymous with the nonfiling gap, and are not a suitable basis for estimating that gap.

Recommendation 2:
Set a deadline for developing data that can be used to measure the performance of its business nonfiler compliance activities overall.

Comment:
We agree to set a deadline for developing data that can be used to measure the performance of IRS business nonfiler compliance activities. The NFEAC governs Servicewide Nonfiler Performance and Outcome Measures for the IRS Enforcement Committee. This topic will be included in the agenda for the September 2010 Nonfiler Executive Advisory Council (NFEAC) quarterly meeting.

Recommendation 3:
Develop a separate efficiency measure for business nonfilers insofar as doing so is cost effective.

Comment:
We agree to develop a separate efficiency measure for business nonfilers if doing so is cost effective. The NFEAC governs Servicewide Nonfiler Performance and Outcome Measures for the IRS Enforcement Committee. This topic will be included in the agenda for the September 2010 NFEAC quarterly meeting. We will determine if it is cost effective to develop a separate BMF Nonfiler Efficiency measure and, if so, assign this for development.

2

Recommendation 4:
Develop an evaluation plan for the BMF CCNIP selection codes, including both an initial evaluation and an ongoing monitoring plan, and conduct a study based on this plan. Results from the study and the ongoing monitoring could be used to refine the selection codes to improve the effectiveness of the program.

Comment:
The BMF CCNIP team conducts weekly analysis to evaluate and monitor the volume, status, select codes, and primary codes of the BMF CCNIP inventory. Each week the team meets to discuss the current Campus inventories and previous week's analysis before they confirm and load the current week's selections. Meeting minutes and analysis are posted to BMF CCNIP's SharePoint site. Additionally, the Team recently held their initial BMF CCNIP annual meeting and met with developers on July 20-21, 2010 to evaluate CCNIP and review planned enhancements. They also reviewed CCNIP Business Objects Reports and will formalize requirements for a "TC 141" report that will provide monthly data on selections. Requirements for the "Select Code Effectiveness Reports" will be developed within six months; however, complete results (i.e., resolution type and dollars collected) will not be available on cases created by CCNIP until the end of FY 2011. Many delinquencies must flow through the entire compliance stream before there is resolution, so data that predicts Select Code "effectiveness" should not be studied until it is complete and available. We expect the TC 141 report to be in production within 90 days and the "Select Code Effectiveness Report" by the end of FY 2011.

Recommendation 5:
Add closing codes that would better indicate all known causes for "not liable to file" determinations and use this information to analyze causes of unproductive cases and use them as appropriate to identify any actions IRS could take either administratively or through education and outreach that could reduce the number of business nonfiler cases where the filing requirement in IRS's records is not applicable.

Comment:
We agree that additional closing codes to capture more specific reasons why BMF taxpayers are determined to be "not liable to file" a tax return may provide opportunities for IRS to improve upon its ability to identify potential nonfilers. The IRS currently uses roughly 30 different closing codes to satisfy modules for which the taxpayer was not liable to file a return. The IRS will conduct a coordinated review of the existing closing codes to determine where capturing additional reasons for not liable determinations would prove valuable for future research efforts. Cost and added complexity may argue for not adding more codes.

Recommendation 6:
Reinforce to collection staff the need to check for business activity using information return data and selection codes.

3

Comment:
The BMF CCNIP Select Code training was developed and presented to Campus Return Delinquency managers and employees this year during Campus Filing and Payment Compliance Program reviews for FY 2010. The material addresses the use of BMF CCNIP Selection Codes as a research tool. With an understanding of the specific third-party criteria for each Select Code, employees can easily determine what type of additional research (i.e., income, payer, or Combined Annual Wage Reporting) is needed to resolve a case and conduct a full-compliance check. The training material will be shared with collection functional training coordinators for reinforcing use of information return data and selection codes to check for business activity.

Recommendation 7:
Study the feasibility and cost-effectiveness of using private sector business activity data and federal contract data to make a determination of whether federal contractors and other businesses are liable for filing tax returns.

Comment:
The Treasury Inspector General for Tax Administration (TIGTA) made a similar recommendation involving the use of private sector data to identify potential nonfilers. In FY 2009, the IRS initiated a study to address the feasibility of using private data sources to identify non-filers not captured by other systems. The IRS' Office of Research looked into what would be required should the IRS decide to purchase private data, and attempts were made to determine what benefits the IRS might realize. They concluded that it is difficult to quantify the benefits because IRS would be purchasing data from information resellers without assurance that the IRS would not receive duplicate records or that the data purchased would produce revenue-generating casework. The most exhaustive marketing data companies have over 14 million listings available. Most IRS data are set up to match on Taxpayer Identification Numbers (TINs), and an automated process to effectively match purchased lists of business names to TINs in IRS systems does not currently exist. A new study involving the use of private sector data will likely produce the same results as the IRS study initiated in FY 2009 and completed March 2010. With regard to using federal contractor data to make a determination for filing tax returns, the IRS will evaluate the effectiveness of data mining using the Central Contractor Registration database maintained by the General Services Administration.

Recommendation 8:
Establish a process similar to the FERDI program for federal workers and retirees that will give a high priority to businesses identified as potential nonfilers that have federal contracts.

Comment:
We will explore the feasibility of establishing a system for prioritizing and routing federal contractor nonfiler cases (i.e., leverage the federal contractor indicator in the nonfiler process through our Inventory Delivery System (IDS). We continue to believe that the IDS is the most cost-effective and efficient way to ensure that high priority cases are brought into active inventory.

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

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

Acknowledgments

In addition to the contact named above, Ralph Block, Assistant Director; Linda Baker; Amy Spiehler; Donna Miller; Jeffrey Niblack; A.J. Stephens; James Ungvarsky; and John Zombro made key contributions to this report.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, http://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548