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FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M. EDT
THURSDAY, SEPTEMBER 18, 1980

UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR

GENERAL GOVERNMENT DIVISION

BEFORE THE

HSE04102

SUBCOMMITTEE ON OVERSIGHT

HOUSE COMMITTEE ON WAYS AND MEANS

ON

THE SUBJECT OF [COMPLIANCE BY FEDERAL

AGENCIES WITH THE REQUIREMENTS

TO FILE 1099 INFORMATION RETURNS]



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DOE AGC020912
CSA AGC02017
Navy AGC02001
BOM AGC02033
Tras.
AGC02004

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Mr. Chairman,

We welcome this opportunity to appear today before your subcommittee to assist you on the subject of improving Federal agencies' compliance with the requirement that they [must file information returns with IRS for non-employee compensation.] We share your concern that, in undertaking any significant efforts to combat underreporting and improve compliance among taxpayers in general, we have to be sure that Federal agencies are complying with the tax laws.

In this regard, much attention has been given to the so-called underground economy during the past several years. Underreporting of individual income is "in vogue," and "the thing to do"--according to many television, newspaper, and magazine accounts.

In July of last year, we testified before your subcommittee on the subject of IRS' efforts to identify and pursue income tax nonfilers and underreporters. At that time, we identified payer compliance with the 1099 filing requirement as a problem area. Also, IRS surveys over the years have consistently shown that many 1099 information documents were not filed by payers. In one study for example, IRS surveyed 4,546 corporations, which were

classified as small, medium, and "no balance sheet" corporate taxpayers, to determine their compliance with filing the form 1099 MISC. Of those, 2,370 were found to have had 1977 transactions which required a form 1099 MISC. IRS determined that 957 or 40 percent of the 2,370 corporations were in full compliance, but that 1,081 or 46 percent had not filed any of the required form 1099 MISC documents, with the remaining 332, or 14 percent, in partial compliance. In another study involving the form 1099 MISC, IRS took a look at the extent to which such documents were being filed by payers for payments to independent contractors. The study revealed that fewer than 60 percent of the required documents were being filed. In addition to developing a new information document (form 1099 NEC) to provide a specific focus on such payments, IRS asked the Congress last year to authorize tax withholding on payments to independent contractors.

Today, at your request, we are focusing our attention on the extent to which some of the larger Federal agencies are complying with the requirement that they file the required information documents for payments made to non-employees. This problem is

particularly critical in view of the well-known low compliance rate by the self-employed for reporting their income to IRS. For example, IRS estimated in its subterranean economy report last year that the self-employed reported only 60 percent of their income. Although estimates vary, Treasury believes that the total revenue loss to IRS because of underreporting by the self-employed is about \$650 million annually.

How to improve independent contractors' compliance with the tax laws has been the subject of much controversy, and we have already testified before another subcommittee that we support Federal withholding in the case of such payments. Obviously the Federal sector should not contribute to the problem of underreporting.

Section 6041 of the Internal Revenue Code requires that persons making payments to others in the course of their trade or business during each calendar year must file the appropriate 1099 information documents with IRS. The payments must total \$600 or more in one year and must be for fixed and determinable salaries, wages, commissions, fees and other forms of compensation for services provided by nonemployees.

Prior to tax year 1979, the 1099-MISC form was used to report such payments to IRS. This form also included other types of payments such as rents and royalties. Beginning with tax year 1979, IRS prescribed a new form -- the 1099 NEC -- to help in identifying payments to nonemployees for compliance purposes.

Our testimony today addresses the extent of non-compliance in this area by Federal agencies, the reasons for noncompliance, IRS' compliance efforts in this area, and some problems and issues associated with compliance which we believe need to be further explored.

None of the agencies included in our review -- IRS, the General Services Administration, and the Departments of the Navy, Interior, and Energy -- were in full compliance with the requirements for filing 1099 information documents with IRS for non-employee compensation. In discussing with these agencies their reasons for noncompliance, we found confusion as to the need to file, and a reluctance to comply because of the perceived complexities associated with the

requirement. IRS has given little attention to enforcing this filing requirement and has not addressed some important issues associated with filing.]

We selected IRS itself for review because it is responsible for administering the tax laws and we wanted to be sure it was complying with its own rules and regulations.

For tax year 1979, IRS' National Office filed 66 information returns for nonemployee compensation such as training courses, consulting services, appraisal services, psychiatric consultation, actuarial services and trial preparation services.

Although it appeared that IRS was substantially complying with its own regulations, we found on a cursory review of payments one instance in which instructor services were provided in calendar year 1979, but were not covered by a corresponding information document. IRS told us that it could not be sure that all of its payments for non-employee compensation that should be covered by a 1099 information document, are, in fact, being identified. Some

payments that should be covered may be "slipping through the cracks" because the accounting unit is making its decision on whether to file 1099s based on incomplete information from the procurement side of the house.

We selected Interior for review because, when IRS raised this compliance problem about 4 years ago with Interior, it had reported that insuring compliance would be almost an impossible task. To our knowledge, IRS has done nothing to enforce compliance. Currently, Interior files no information returns whatsoever for nonemployee compensation.

In our recent discussions with Interior's procurement and accounting officials, they cited some of the difficulties they would face in attempting to comply. They told us it is difficult to establish whether an unreportable product or a reportable service were obtained; and moreover, it would be difficult to redesign the accounting system to aggregate such payments. These officials also believed that Interior is not subject to the filing requirements of Section 6041 of the Internal Revenue Code because they have not received implementing regulations from Treasury.

Curiously, however, one of Interior's constituent agencies - Bureau of Mines - is properly filing 1099 MISCs for death claims. For example, the Bureau files a 1099 MISC if an employee dies during a pay period and the beneficiary is paid in a lump sum.

Navy, which reportedly has the most consulting service contracts in the Department of Defense, does not routinely file 1099 information documents for nonemployee compensation. Navy officials told us that they file only when the person to whom the payments are being made asks for it or if the payment is for a death claim.

The Department of Energy is another heavy user of independent contractors and consultants - the types of contracts that are most likely subject to 1099 filing requirements. Some of the services being provided to DOE in 1980 were for research and evaluation, repair and maintenance, reporting and transcribing, and training.

DOE has 5 finance offices including the National Office in Washington, D.C.. As a result of our inquiries, the Agency, surveyed its finance offices and found that only its Oak Ridge Finance Office filed 1099 MISCs for tax year 1979. As a result, the Director, Office of Finance and Accounting, issued a memorandum to the responsible

offices directing that appropriate action be taken to insure full compliance with the 1099 filing requirements for calendar year 1980.

We contacted DOE's Oak Ridge Finance Office to determine why it was apparently complying with the 1099 filing requirements when DOE's other 4 finance offices were not. The Director told us that he was personally aware of the filing requirements from past experience and as a result of his research of the tax laws. He said he had received no Headquarters guidance on this requirement.

GSA, the Government's central procurement agency, was not aware of the requirement to file information returns for non-employee compensation. GSA told us it would be a monumental task to modify its accounting systems to comply. Further, GSA officials said that it would not comply unless directed to do so.

Most agencies we reviewed could not readily determine the amount of payments that were subject to 1099 reporting because their information systems were not designed to do so. We observed that the payment documents did not contain the information needed to alert the accounting function about the filing requirement. For example, there were no records to

show whether the payments were being made for nonemployee compensation. In addition, we observed that some information documents did not contain the taxpayer's identification number, which is needed in IRS' document matching program.

In an attempt to get an idea of how many payments were not being covered by 1099 MISCs, we sampled some DOE purchase orders because, as we mentioned previously, DOE is a heavy user of consulting services and independent contractors. DOE's Finance Office at its Washington Headquarters provided us with a computer printout which listed small purchase orders - \$10,000 or less -- for various services in fiscal year 1980. From the listing, we selected non-corporate contractors, both individuals and partnerships, which received aggregate payments of \$600 or more. Based on our subjective selection, we calculated that about 175 purchase order actions or about 16 percent of the total 1,049 actions listed were subject to the filing requirements, but had not been reported. This amounted to about \$649,000 or 18% of the \$3,567,000 total estimated value of the purchase orders

checked. The amount of taxes actually lost is a function of taxpayer honesty and the tax rates applicable to the unreported income.

(A related issue concerns incorporated professionals such as consultants, lawyers, accountants, etc.. Under the IRS regulations, payments to corporations are exempted from the filing requirements unless they are for health services.) For example, if a lawyer or a management consultant provides his professional services as an individual, the payer is subject to the 1099 filing requirements. If the same person incorporates himself, payments to him are not subject to the filing requirement. In our discussions with them, (IRS officials have acknowledged this inconsistency and stated that payments to corporations have been exempted from the 1099 filing requirements since 1918, except for those providing medical payments. In 1971 medical payments became subject to the requirements in order to prevent Medicare and Medicaid abuses.)

In our discussions with IRS officials, we learned that (they were not fully aware of the extent of problem.) (Further, IRS's main tool for enforcing compliance is to audit the taxpayer's

records -- a technique not ordinarily applied to Federal agencies.) It is clear that [action is needed to

- clarify Federal agencies' responsibilities to file information returns for nonemployee compensation,
- provide for the accumulation of the necessary information in the agencies' management information systems,
- clarify the distinction between product and service, and
- enforce the Internal Revenue laws with regard to Federal agencies.

IRS needs to immediately alert the Department heads of all Federal agencies that a serious noncompliance problem may exist in their respective agencies. In addition, IRS should request the Department of the Treasury to clarify the reporting requirements and procedures included in the Treasury Fiscal Manual for Guidance of Federal Agencies. IRS should follow these actions with a regular program that would check on Federal agencies to ensure that they are complying with all tax requirements. IRS should also clarify ambiguities in the instructions. For example, a clear distinction should be made between what constitutes a product versus what constitutes a service.

We also recommend that IRS review its implementing regulations to determine if other filing requirements are in need of clarification and/or revision. In this regard, IRS should consider requiring that payments for professional services by lawyers, accountants and other professionals be subject to 1099 filing requirements regardless of whether these services are furnished by an individual or by a corporation.

Mr. Chairman, this concludes our prepared statement. We shall be pleased to respond to questions.