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SMALL BUSINESSES

Tax Compliance Benefits and Opportunities to Mitigate Costs on Third Parties of Miscellaneous Income Reporting Requirements

Statement of James R. White, Director
Strategic Issues

GAO

Accountability * Integrity * Reliability

Highlights of GAO-11-218T, a testimony before the Committee on Small Business and Entrepreneurship, U.S. Senate

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Tax Compliance Benefits and Opportunities to Mitigate Costs on Third Parties of Miscellaneous Income Reporting Requirements

Why GAO Did This Study

Third parties, often businesses, reported more than $6 trillion in miscellaneous income payments to the Internal Revenue Service (IRS) in tax year 2006 on Form 1099-MISC. Payees are to report this income on their tax returns. It has been long known that if these payments are not reported on 1099-MISCs, it is less likely that they will be reported on payee tax returns. In 2010, the reporting requirements were expanded to cover payments for goods and payments to corporations, both previously exempt, beginning in 2012.

This testimony summarizes recent GAO reports and provides information on (1) benefits of the current requirements in terms of improved compliance by taxpayers and reduced taxpayer recordkeeping, (2) costs to the third-party businesses of the current 1099-MISC reporting requirement, and (3) options for mitigating the reporting burden for third-party businesses. GAO has not assessed the expansion of 1099-MISC reporting to payments for goods.

What GAO Recommends

GAO is not making new recommendations in this testimony. In 2009, GAO suggested that Congress consider requiring payers to report service payments to corporations. GAO did not study reporting of payments for goods. Other prior GAO recommendations included ways for IRS to improve its use of 1099-MISC information received. IRS agreed with six of eight recommendations and is taking action to address them.

View GAO-11-218T or key components.
For more information, contact James R. White, at (202) 512-9110 or whitej@gao.gov.

What GAO Found

Information reporting is a powerful tool for encouraging voluntary compliance by payees and helping IRS detect underreported income. Also, information reporting may sometimes reduce taxpayers' costs of preparing their tax returns, although by how much is not known. IRS estimated that $68 billion of the annual $345 billion gross tax gap for 2001, the most current available estimate, was caused by sole proprietors underreporting their net business income. A key reason for this noncompliance was that sole proprietors were not subject to tax withholding and only a portion of their net business income was reported to IRS by third parties. The benefits from information reporting are affected by payers' compliance with reporting requirements and IRS's ability to use the information in its process that matches third-party data with tax returns. However, IRS does not have estimates of the number or characteristics of payers that fail to submit 1099-MISCs as required. To improve its use of 1099-MISC information, IRS has collected data to help identify ways to refine its matching process and select the most productive cases for review, as GAO recommended in 2009.

Current 1099-MISC requirements impose costs on the third parties required to file them. The magnitude of these costs is not easily estimated because payers generally do not track these costs separate from other accounting costs. In nongeneralizable case studies conducted in 2007 with four payers and five vendors that file information returns on behalf of their clients, GAO was told that existing information return costs were relatively low. One small business employing under five people told GAO of possibly spending 3 to 5 hours per year filing Form 1099 information returns manually, using an accounting package to gather the information. Two vendors reported prices for preparing and filing Forms 1099 of about $10 per form for 5 forms to about $2 per form for 100 forms, with one charging about $0.80 per form for 100,000 forms. However, these prices did not include clients' recordkeeping costs. Payers face a variety of impediments preparing and submitting 1099-MISC forms, including complex rules and an inconvenient submission process. For example, payers must determine whether payees are incorporated, must get the payees' taxpayer identification number, and must use special forms if filing on paper.

A variety of options exist for mitigating the costs of filing Form 1099-MISC. Most have pros and cons. IRS has already exempted payments, including those paid by credit card, which will be reported to IRS by other means. Other options include improving IRS guidance and education; adding a check-the-box question to business tax forms that would force return preparers to ask their clients whether they have complied with 1099-MISC reporting requirements; waiving late submission penalties for first-time payers; raising the payment reporting threshold; initially limiting the types of payments covered; having IRS develop an online filing capability; and allowing paper filers to submit computer-generated black and white 1099-MISCs rather than IRS's printed forms.

Madam Chair and Members of the Committee:

I am pleased to be here today to discuss the effects on small businesses of filing third-party information returns with the Internal Revenue Service (IRS) reporting various payments. Payees are responsible for reporting payments they received from the third-party payers as income on their tax returns. This income is labeled miscellaneous income and reported by the third parties on Form 1099-MISC. IRS matches the third-party information returns with payees' tax returns to ensure that payees are accurately reporting their income and paying any tax. Third parties reported more than $6 trillion in payments for tax year 2006 on Forms 1099-MISC.

Information reporting by third parties is a proven approach for improving taxpayer compliance with the tax laws and for minimizing taxpayers' costs of complying. However, such reporting imposes a cost on the third parties. Consequently, there is a trade-off. Our tax system shifts some of the costs of tax administration to the third parties and gains improved compliance and reduced compliance costs for taxpayers.

This trade-off is illustrated by the requirement for additional reporting of miscellaneous income. Section 9006 of the Patient Protection and Affordable Care Act[1] requires expanded information reporting to include payments to corporations and payments of amounts in consideration of property and gross proceeds. For payments after December 31, 2011, every person engaged in a trade or business would be required to file a Form 1099-MISC reporting aggregate annual payments of more than $600 to any individual or corporate payee for the purchase of goods or services.[2] Currently, information reporting is only required for payments for services and only to payees who are not incorporated. Concerns have been expressed about the costs that the additional reporting will impose on businesses. The Joint Committee on Taxation estimates that eliminating the new requirement would result in revenue loss of approximately $19 billion from 2012 to 2020 from increased taxpayer noncompliance.

[1]Pub. L. No. 111-148, Title IX, Subtitle A, 124 Stat. 119 (Mar. 23, 2010).

[2]Section 9006 expanded information reporting to include payments of amounts in consideration for property and payments of gross proceeds. In its July 19, 2010 Notice 2010-51 requesting public comment on these amendments to information reporting, IRS specifically asked the public to comment on the appropriate scope of the terms and how to interpret the terms in a manner that minimizes the reporting burden and avoids duplicative reporting.

In 2009, we suggested that Congress consider requiring payers to report service payments to corporations on the Form 1099-MISC, but we have not assessed or recommended expanding 1099-MISC reporting to payments for goods.[3] As early as 1991, we determined that the benefits in terms of increased tax revenue and voluntary taxpayer compliance would exceed the costs of extending 1099-MISC reporting to corporate payments.[4] IRS agreed that the benefits of eliminating the corporate exemption for service payments outweigh the costs, and the Bush Administration had proposed legislation extending the reporting requirements to service payments to corporations. The Obama Administration had similar proposals in its fiscal year 2010 and 2011 budget requests.[5]

Because of the debate about the cost imposed by the new requirement, you asked us to summarize our prior reports on what is known about the costs and compliance benefits of information reporting, particularly 1099-MISC reporting.[6] More specifically, our objectives are to describe (1) what is known about the benefits of the current requirements in terms of both improved compliance by taxpayers and reduced taxpayer recordkeeping and other costs, (2) what is known about the costs to the third-party businesses of the current 1099-MISC reporting requirement, and (3) what opportunities are available to mitigate the reporting burden for third-party businesses. The reports we summarize in this statement did not assess the expansion of 1099-MISC reporting to payments for goods.

My testimony today is based on three reports on information reporting by third parties. We used multiple methodologies to develop our findings for

[3] GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238 (Washington, D.C.: Jan. 28, 2009). In this report, we made eight recommendations to IRS, six of which IRS agreed with and is taking action to address.

[4] GAO, *Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs*, GAO/GGD-91-118 (Washington, D.C.: Sept. 27, 1991).

[5] According to the Department of the Treasury's estimates, the Obama Administration's fiscal year 2011 proposal for reporting payments to corporations would have generated an estimated $9.2 billion from 2011 through 2020, in part because of increased voluntary compliance. However, the Joint Committee on Taxation estimated that the Administration's 2011 proposal would have generated about $3.4 billion for the same period.

[6] GAO-09-238; *Tax Administration: Costs and Uses of Third-Party Information Returns*, GAO-08-266 (Washington, D.C.: Nov. 20, 2007); and *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

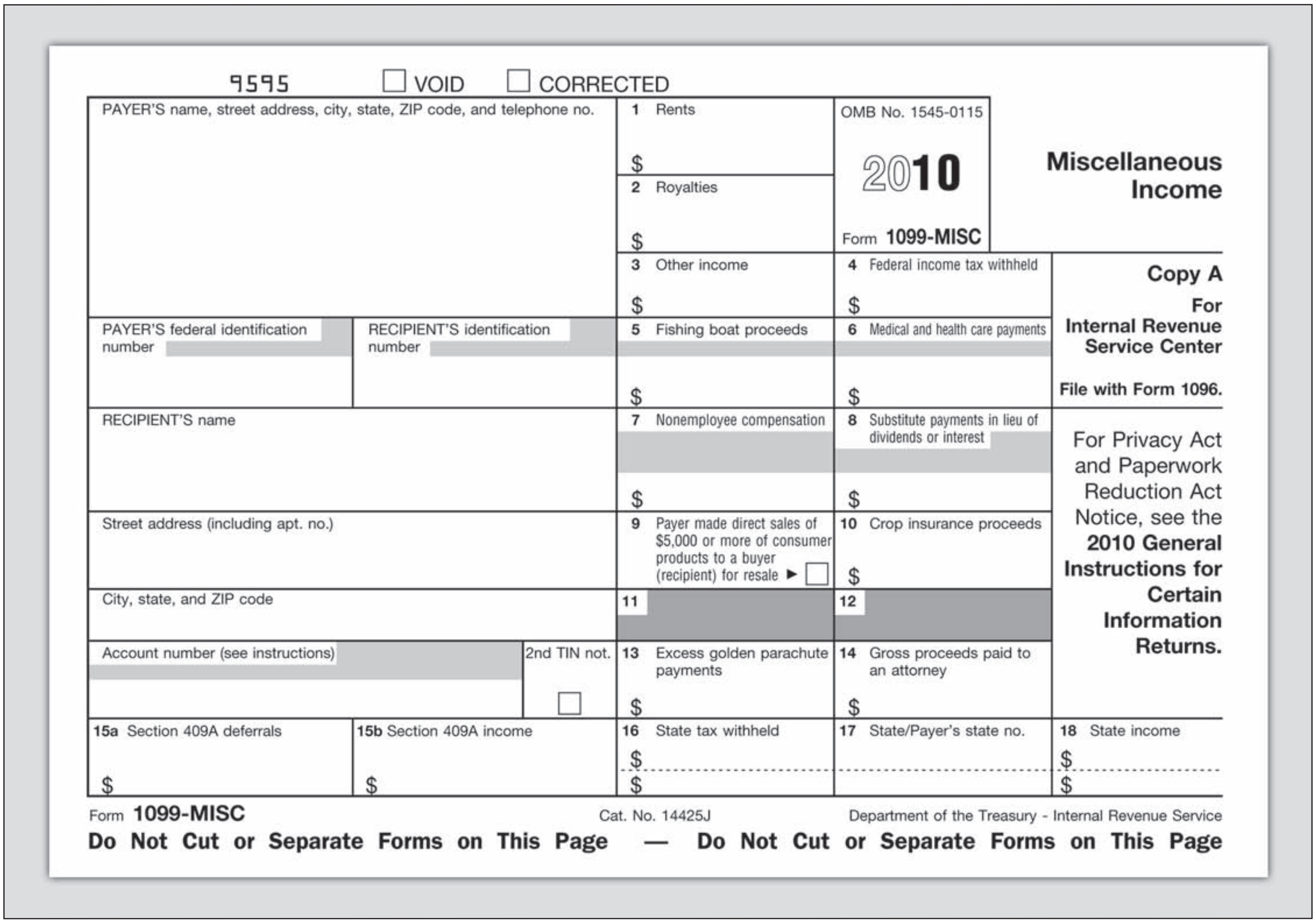
these reports. We conducted structured interviews with four organizations volunteered through International Accounts Payable Professionals or the National Federation of Independent Businesses, an organization of small businesses that was on record as finding the information reporting proposals we studied to be troublesome to small businesses. We also selected five companies from lists of vendors, IRS-approved electronic filers, and Information Reporting Program Advisory Committee members, enough to include representatives of software vendors, service bureaus, and return preparers and cover a sizable percentage of all information returns. These nine case studies provide examples of costs related to 1099s, including 1099-MISCs, but are not representative of the general population of payers and are not to be generalized. We interviewed IRS officials and members of IRS advisory groups, tax professionals, and tax software and information return filing vendors to identify impediments facing payers in preparing and submitting 1099-MISCs. In addition, we reviewed IRS documents and compliance data. We conducted our work for these three reports in accordance with generally accepted government auditing standards. A more detailed discussion of scope and methodology is available in each of the three reports.

Background

As we reported in 2009, more than 5 million third parties submitted more than 82 million miscellaneous income information forms (Form 1099-MISC) to the IRS reporting more than $6 trillion in payments for tax year 2006. Third-party payers are businesses, governmental units, and other organizations that make payments to other businesses or individuals. Payers must submit payment information on 1099-MISCs to IRS when they make a variety of payments labeled miscellaneous income. Payees, or those being compensated, are required to report the payments on their income tax returns.

The types of payments reportable on a Form 1099-MISC—shown in figure 1—and their reporting thresholds vary widely. Under existing law, information reporting is required for payments by persons engaged in a trade or business to nonemployees for services of $600 or more (called nonemployee compensation), royalty payments of $10 or more, and medical and health care payments made to physicians or other suppliers (including payments by insurers) of $600 or more. However, personal payments, such as a payment by a homeowner to a contractor to paint his or her personal residence, are not required to be reported because these payments are not made in the course of a payer's trade or business. Existing regulations also exempt certain payments to a corporation, payments for merchandise, wages paid to employees, and payments of rent to real estate agents.[7] The expansion of information reporting to payments to corporations and for merchandise will apply to payments made after December 31, 2011.

Figure 1: Form 1099-MISC, Tax Year 2010


9595 VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.

1 Rents $

2 Royalties $

OMB No. 1545-0115

2010

Form 1099-MISC

Miscellaneous Income

3 Other income $

4 Federal income tax withheld $

Copy A For Internal Revenue Service Center

File with Form 1096.

PAYER'S federal identification number

RECIPIENT'S identification number

5 Fishing boat proceeds $

6 Medical and health care payments $

RECIPIENT'S name

7 Nonemployee compensation $

8 Substitute payments in lieu of dividends or interest $

For Privacy Act and Paperwork Reduction Act Notice, see the **2010 General Instructions for Certain Information Returns.**

Street address (including apt. no.)

9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ►

10 Crop insurance proceeds $

City, state, and ZIP code

11

12

Account number (see instructions)

2nd TIN not.

13 Excess golden parachute payments $

14 Gross proceeds paid to an attorney $

15a Section 409A deferrals $

15b Section 409A income $

16 State tax withheld $ $

17 State/Payer's state no.

18 State income $ $

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

Source: IRS.

Note: The 2010 form reflects current law in effect and does not include reporting on payments for goods.

[7] Treasury Regulations §1.6041-3. See GAO, *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

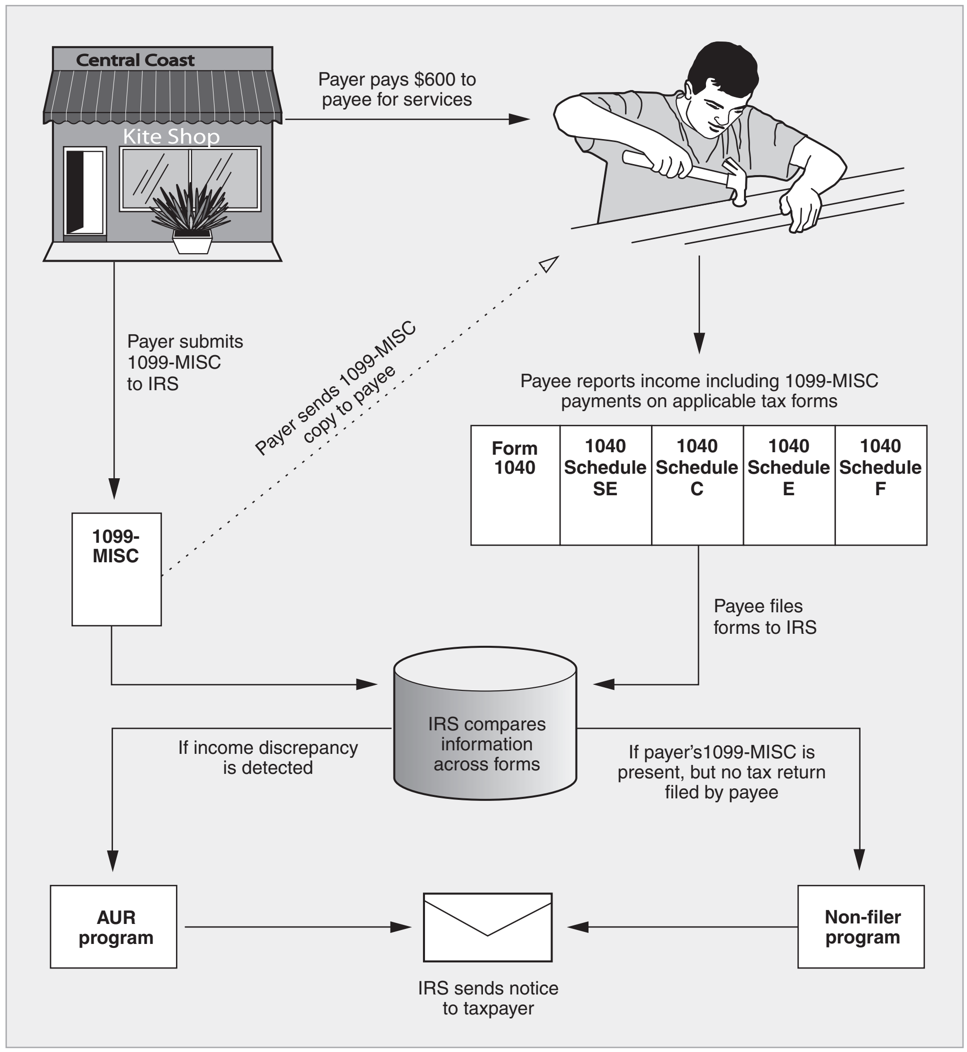
Payers must provide 1099-MISC statements to payees by the end of January. Payers submitting fewer than 250 1099-MISCs may submit paper forms, which are due to IRS by the end of February. Payers submitting paper 1099-MISCs are required to use IRS's official forms or substitute forms with special red ink readable by IRS's scanning equipment.[8] Photocopies and copies of the 1099-MISC form downloaded from the Internet or generated from software packages in black ink do not conform to IRS processing specifications. Payers submitting 250 or more 1099-MISCs are required by IRS to submit the forms electronically.[9] Most 1099-MISCs for tax year 2006 were submitted electronically. However, most payers submitted small numbers of 1099-MISCs, and most payers submitted paper 1099-MISCs.

By matching 1099-MISCs received from payers with what payees report on their tax returns, IRS can detect underreporting of income including failure to file a tax return. Figure 2 shows the automated process IRS uses to detect mismatches between nonemployee compensation and other payments reported on 1099-MISCs and payees' income tax returns. The Nonfiler program handles cases where no income tax return was filed by a 1099-MISC payee. The Automated Underreporter (AUR) program handles cases where a payee filed a tax return but underreported 1099-MISC payments. AUR's case inventory includes payee mismatches over a certain threshold, and IRS has a methodology using historical data to select cases for review. AUR reviewers manually screen the selected cases to determine whether the discrepancy can be resolved without taxpayer contact. For the remaining cases selected, IRS sends notices asking the payee to explain discrepancies or pay any additional taxes assessed.

[8] IRS uses the Service Center Recognition Image Processing System (SCRIPS) to capture printed or handwritten information from paper forms and convert the information into machine-readable format for computer processing.

[9] 26 U.S.C. § 6011(e)(2)(A).

Figure 2: Matching 1099-MISC Reportable Nonemployee Compensation Information with Individual Tax Returns

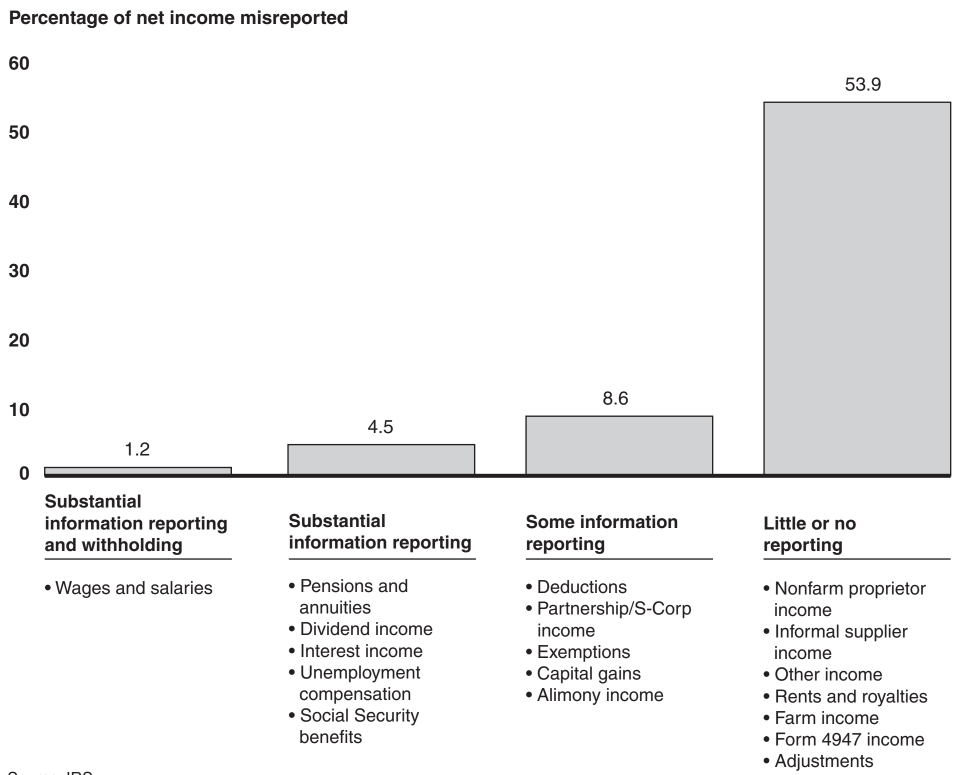


Source: GAO analysis of IRS information.

1099-MISC Information Reporting Increases Voluntary Taxpayer Compliance, Reduces the Cost and Intrusiveness of IRS Compliance Programs, and May Reduce Payees' Costs of Preparing Their Tax Returns

Third-party information reporting is widely acknowledged to increase voluntary tax compliance in part because taxpayers know that IRS is aware of their income. As shown in figure 3, voluntary reporting compliance is substantially higher for income subject to withholding or information reporting than for other income. For example, for wages and salaries, which are subject to withholding and substantial information reporting, taxpayers have consistently misreported an estimated 1 percent of their income. For income with little or no information reporting, the tax year 2001 estimated percentage was about 54 percent. IRS has long recognized that if payments made to businesses are not reported on 1099-MISCs, it is less likely that they will be reported on payee tax returns.

Figure 3: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting, Tax Year 2001



Source: IRS.

In a 2007 report we highlighted the connection between a lack of information reporting and the contribution of sole proprietors, a significant portion of the small business community, to the tax gap.[10] IRS estimated the gross tax gap—the difference between what taxpayers actually paid and what they should have paid on a timely basis—to be $345 billion for tax year 2001, the most recent estimate made. IRS also estimated that it will collect $55 billion, leaving a net tax gap of $290 billion. IRS estimated that a large portion of the gross tax gap, $197 billion, was caused by the underreporting of income on individual tax returns. Of this, IRS estimated that $68 billion was caused by sole proprietors underreporting their net business income. The $68 billion does not include other sole proprietor contributions to the tax gap, including not paying because of failing to file a tax return, underpaying the tax due on income that was correctly reported, and underpaying employment taxes. Nor does it include tax noncompliance by other types of businesses such as partnerships and S corporations. In the report, we noted that a key reason for this noncompliance was that sole proprietors were not subject to tax withholding, and only a portion of their net business income was reported to IRS by third parties. Tax noncompliance by some small businesses is unfair to businesses and other taxpayers that pay their taxes—tax rates must be higher to collect the same amount of revenue.

The 1099-MISCs are a powerful tool through which IRS can encourage voluntary compliance by payees and detect underreported income of payees that do not voluntarily comply. Increasing the numbers of 1099-MISCs IRS receives from payers in turn would increase information available for use in IRS's automated matching programs to detect tax underreporting, including failure to file a tax return. For tax year 2004 (the last full year available for our 2009 report), the AUR program assessed $972 million in additional taxes for payee underreporting detected using 1099-MISC information.[11] To help IRS improve its use of 1099-MISC information, we recommended in 2009 that IRS collect data to help refine its matching process and select the most productive cases for review. In response to our recommendation, IRS reviewed a sample of AUR cases and plans to modify its tax year 2010 matching criteria for 1099-MISC information.

[10] GAO-07-1014.

[11] GAO-09-238.

Information reporting has allowed IRS to use its computerized matching programs as an alternative to audits to address some issues. The matching programs generally require less contact with taxpayers and thus are less intrusive and involve less taxpayer time.

In addition, information reporting may reduce taxpayers' costs of preparing their tax returns. In a 2006 report we described how additional information reporting on the basis of securities transactions could reduce taxpayers' need to track the basis of securities they sold.[12] The extent to which 1099-MISC reporting reduces taxpayer recordkeeping costs is not known, but to the extent it reduces the need to track receipts by year from each payer it could have some effect on those costs.

IRS does not know the magnitude of 1099-MISC payer noncompliance or the characteristics of payers that fail to comply with the reporting requirements. Without an estimate of payer noncompliance, IRS has no way of determining to what extent 1099-MISC payer noncompliance creates a window of opportunity for payees to underreport their business income and go undetected by IRS. Research would be key for IRS in developing a cost-effective strategy to identify payers that never submit 1099-MISCs. In 2009, we recommended that IRS study the extent of 1099-MISC payer noncompliance and its contribution to the tax gap, as well as the nature and characteristics of those payers who do not comply.[13] In response to our recommendations, IRS plans to study payer noncompliance through its National Research Program studies with results estimated to be available in December 2015.

[12] GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

[13] GAO-09-238.

Third Parties Incur Costs to File 1099-MISCs, but Case Study Entities Reported That the Costs of Complying with Current Requirements Were Relatively Low

Existing information reporting requirements impose costs on the third-party businesses required to file Form 1099-MISC. The expanded reporting requirements will impose new costs. To comply with information reporting requirements, third parties incur costs internally or pay external parties. In-house costs may involve additional recordkeeping costs beyond normal recordkeeping costs related to running a business, as well as the costs of preparing and filing the information returns themselves. If the third parties go outside their organizations for help, they would incur out-of-pocket costs to buy software or pay for others to prepare and file their returns.

Data on the magnitude of these information reporting costs are not readily available because taxpayers generally do not keep records of the time and money spent complying with the tax system. A major difficulty in measuring tax compliance costs, including the costs of filing information returns, is disentangling accounting and recordkeeping costs due to taxes from the costs that would have been incurred in the absence of the federal tax system. Data on compliance costs are typically collected by contacting a sample of taxpayers, through surveys or interviews, and asking them for their best recollection of the total time and money they spent on particular compliance activities. The quality of the resulting data depends on the ability of taxpayers to accurately recall the amount of time and money they spent.

In the nine case studies we conducted in 2007, filers of information returns told us that existing information return costs, both in-house and for external payments, were relatively low. While these nine case studies are not to be generalized to the entire population, they do provide examples of costs and insights from the perspective of organizations of different sizes and from different industries and of organizations filing their own information returns and those filing on behalf of others.[14] In-house compliance costs include the costs of getting taxpayer identification numbers (TIN), buying software, tracking reportable payments, filing returns with IRS, and mailing copies to taxpayers.

- One organization with employees numbering in the low thousands estimated that its costs of preparing and filing a couple hundred Forms 1099, which include recordkeeping and distinguishing goods from services, were a minimal addition to its normal business costs.

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[14]For additional details on our case studies, see GAO-08-266.

- One small business employing under five people told us of possibly spending 3 to 5 hours per year filing Form 1099 information returns manually, using an accounting package to gather the information.

- An organization with more than 10,000 employees estimated spending less than .005 percent of its yearly staff time on preparing and filing Forms 1099, including recordkeeping.

- Unit prices for services provided to payers by selected software vendors, service bureaus, and return preparers decreased as the number of forms handled increased. Two external parties selling services reported prices for preparing and filing Forms 1099 with IRS of about $10 per form for 5 forms to about $2 per form for 100 forms, with one of them charging about $0.80 per form for 100,000 forms. These prices do not include the payers' recordkeeping costs.

This relationship of price to size for entities we studied is consistent with what studies that we have seen show about the role of fixed costs and economies of scale in complying with the tax code; we are familiar with no similar studies of information returns.[15]

Although our case study organizations indicated that 1099 recordkeeping and reporting costs are relatively low, costs may not be as low as they could be. According to IRS, advisory group members, and others we interviewed for our 2009 report, payers are confronted with a variety of impediments to preparing and submitting 1099-MISC forms.[16] Some payers that do not submit their 1099-MISCs as required may be unaware of their 1099-MISC reporting responsibilities. Other payers may be confused about whether payments are reportable because of different dollar reporting thresholds and the general exemption for payments to corporations under current law. Some payers misreport or neglect to report payee taxpayer identification numbers (TIN) and could be subject to penalty and required

[15]According to Slemrod and Bakija, studies consistently found that the smaller the firm, the larger the cost of complying with the tax system per dollar of various measures of the size of the firm. (See Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes*, 3rd ed. (Cambridge, Mass.: The MIT Press, 2004.)

[16]IRS advisory groups include the Electronic Tax Administration Advisory Committee (ETAAC), the Information Reporting Program Advisory Committee (IRPAC), and the Internal Revenue Service Advisory Council (IRSAC). We also interviewed tax professionals, tax software vendors, paid preparers, and other business and professional association representatives knowledgeable about 1099-MISC payer reporting attending the IRS National Public Liaisons (NPL) fall 2007 meeting.

to do backup withholding on 1099-MISC payments to payees with bad TINs. For the large number of payers each submitting a few 1099-MISCs, IRS does not offer a fillable form on its Web site and requires payers to submit scannable red ink forms, but some payers submit black and white 1099-MISCs anyway.

Opportunities Exist to Mitigate the Burden and Promote Reporting Compliance for Third Parties Submitting 1099-MISC Information Returns

Although businesses will face additional costs for each additional Form 1099, some options for modifying the 1099-MISC reporting requirements could help mitigate the burden and promote payer reporting compliance. Table 1 highlights options we previously reported. We noted those options that were proposed by IRS, IRS advisory groups, and the National Taxpayer Advocate.[17] Our list of 1099-MISC impediments and options is not exhaustive, nor is the list of pros and cons associated with the options. Improved IRS guidance and education are relatively low-cost options, but most taxpayers use either tax preparers or tax software to prepare their tax returns and may not read IRS instructions and guidance. While taxpayer service options may improve compliance for those that are inadvertently noncompliant, they are not likely to affect those that are intentionally noncompliant.[18] Some options to change 1099-MISC reporting requirements require congressional action, and other options would be costly for IRS to implement. Where the option involves particular issues, such as cost or taxpayer burden, we note them in our table.

[17]The table notes options specifically recommended by IRS's advisory groups or by IRS in its budgets and tax gap plans at the time of our 2009 report on reporting miscellaneous income.

[18]GAO, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential*, GAO-08-703SP (Washington, D.C.: June 2008).

Table 1: Impediments to 1099-MISC Payer Reporting Compliance and Options for Increasing Voluntary 1099-MISC Compliance

Impediments facing 1099-MISC payers	Options for increasing voluntary compliance and related actions, pros, and cons
Some payers are unaware of their 1099-MISC reporting responsibilities	

1. Some payers are unaware of their 1099-MISC reporting responsibilities.	• Revise business tax form instructions to remind taxpayers of 1099-MISC reporting requirements for specific expense types.
	  • IRS added a 1099-MISC reminder to the 2007 Schedule C instructions for contract labor expenses, and such reminders can be added for other 1099-MISC reportable expenses such as rent and legal and professional services.
	• Target 1099-MISC related education and outreach activities to specific payer groups (IRSAC, 2005; IRS Oversight Board, 2008).[a]
	  • IRS has initiated such outreach to federal, state, local, and tribal governments, but more research is needed to determine which business payer groups to target.
	In response to our 2009 recommendation, IRS added a general reminder to the 2009 *Publication 535 Business Expenses* to highlight 1099-MISC reporting responsibilities.
	All of the above may be of limited efficacy if taxpayers rely on paid preparers and tax preparation software and do not look at IRS instructions or guidance, or if taxpayers are willfully misreporting. Providing additional guidance could be helpful if tax return preparation software is based on the guidance.
	• Increase outreach to paid preparers and tax software vendors to promote awareness of 1099-MISC reporting responsibilities (IRSAC, 2005).
	  • Providing 1099-MISC training outreach through IRS's phone forums or Nationwide Tax Forums can reach large numbers of paid preparers. At the 2010 Tax Forums, IRS discussed ways to properly report 1099-MISC payment information.
	  • Many payers rely on paid preparers and tax software to help them comply with their reporting responsibilities.
	• Add check-the-box question to business tax forms requiring taxpayers to attest whether they submitted 1099-MISCs related to their reported expenses (IRSAC, 2005; National Taxpayer Advocate, 2005).
	  • Would force tax preparers and tax software to query taxpayers about their expenses, and taxpayers would have to respond to the checkbox under penalty of perjury.
	  • According to the National Taxpayer Advocate, the burden associated with a checkbox asking taxpayers to verify that they have complied with existing legal requirements is inherently small.
	  • Impact may be on increasing voluntary compliance, with little utility as an IRS enforcement tool.
	  • California has a similar checkbox on state corporation and S-corporation income tax returns, which serves as a reminder to taxpayers. California has not evaluated how this reporting feature affects payer reporting compliance.
	• Add a chart in the business income tax instructions to help payers determine if they have a potential 1099-MISC reporting requirement and need to review the 1099-MISC instructions. IRS frequently provides charts and worksheets to help taxpayers understand their filing obligations.[b]

2.	Some payers first learn about 1099-MISC reporting responsibilities from their tax preparers after 1099-MISC due dates have passed.	• Add IRS's "Information Returns Processing" hyperlink to its "Starting a Business" and "Small Business and Self-Employed Tax Center" sites to make information reporting a more prominent aspect of business responsibilities.
		• Provide a general notice about 1099-MISC reporting responsibilities to new small business owners when they apply for an employer identification number (EIN).
		  • IRS currently encourages online application and provides EINs immediately after validation which makes this a low cost option.
		• Provide a notice about 1099-MISC reporting responsibilities, key requirements, and due dates to small businesses each fall. Notices could be sent to some businesses, such as Schedule C filers reporting contract labor expenses for the first time, or all small businesses.
		  • Potentially costly mailing. May not be cost-effective if large numbers of businesses do not have 1099-MISC reportable payments.
		• Have single due date for 1099-MISC submission to IRS.
		  • Change paper submission due date to IRS from February 28 to March 31 to encourage taxpayers and tax preparers to prepare any 1099-MISCs that may have been overlooked without fear of penalty (IRSAC, 2005).
		  • Change electronic submission due date to IRS from March 31 to February 28 to allow IRS more time to process 1099-MISC for computer matching (Electronic Tax Administration Advisory Committee (ETAAC), 2006).
		  • Changing due dates for submitting 1099-MISC to IRS affects due dates for other information return series, but does not change the January due date to payees.
		• Waive late submission penalties for first-time payers.
		  • Some payers who realize they are late in submitting 1099-MISCs may choose not to file rather than run the risk of incurring late penalties. IRS already reduces the late penalty for 1099-MISCs submitted before August 1 to encourage voluntary submissions.
		  • Hard for IRS to distinguish first-time payers that may have reasonable cause for being late from payers that have willfully neglected to submit 1099-MISCs. Thus, this option may require legislative action to grant IRS authority to automatically waive the late penalty for 1099-MISC payers reporting for the first time.

Some payers are confused about 1099-MISC requirements	
3. Under existing guidance, payers must navigate through 8 pages of singled-spaced instructions to determine what to report in the 14 boxes on the 1099-MISC.	• Add a chart in the 1099-MISC instructions for distinguishing 1099-MISC reportable from non-reportable payments and for calculating whether reportable payments reached reporting threshold. For example, IRS General Instructions for Forms 1099, 1098, 5498 and W-2g contain a chart highlighting what payments and amounts to report for various information returns, including Form 1099-MISC. • Clarify guidance to address common misreporting errors. • IRS does not have research identifying the reasons for payer reporting problems.
4. Some payers overlook reporting payments for non-routine or sporadic one-time transactions.	• Revise business tax form instructions to remind taxpayers of 1099-MISC reporting requirements for specific expense types.

5. Payers must determine whether payments are reportable due to different reporting thresholds. Some payers may underreport miscellaneous income types, such as royalties, with thresholds lower than $600.	• Add a chart in the 1099-MISC instructions for distinguishing 1099-MISC reportable from non-reportable payments and for identifying whether reportable payments reached reporting threshold. Similarly, adding a chart in the business income tax instructions could help payers determine if they have a potential 1099-MISC submission requirement and need to review the full instructions.
	• Standardize or eliminate dollar threshold for reporting payments (NTA, 2005; IRPAC, 2006).[c]
	    • Lower uniform amount (National Taxpayer Advocate, 2005).
	        • Increased payer burden to submit more 1099-MISCs.
	        • Increased number of 1099-MISCs to IRS for detecting payee income underreporting.
	    • Higher uniform amount.
	        • Decreased payer burden.
	        • Decreased number of 1099-MISCs to IRS for detecting payee income underreporting.
	    • Some options to change the dollar reporting threshold require legislative action.

6.	Under current law, payers must determine whether payee is a corporation that is exempt from 1099-MISC reporting.	• Amend legislation—as was achieved under the broader reporting requirements enacted in 2010—to extend reporting requirements to include service payments to corporations. We previously reported that the benefits in terms of increased revenue and taxpayer compliance exceed costs for reporting service payments to corporations. In 1991, we suggested that Congress needed to enact legislation to require reporting on payments to corporations and in 2009 formally recommended that matter for congressional consideration.[d] IRS agrees that the benefits of this option in addressing the tax gap outweigh the costs. The Bush Administration requested legislative action in its fiscal year 2008 and 2009 budgets and the Obama Administration in its fiscal year 2011 budget. According to Treasury estimates, extending the reporting to payments to corporations would generate revenue due in part to increased voluntary compliance and IRS's ability to detect underreported payments received by businesses.
		• The burden of determining the payee's status would be simplified. Some payers already submit 1099-MISC for all corporate payees rather than determine payee status. (IRSAC, 2005). However, other payers fail to submit 1099-MISCs currently required because they mistake small business payees as corporations exempt from reporting.
		• Payers need to submit more 1099-MISCs (IRPAC, 2007). Various phase-in options could minimize the burden and disruption for payers.[e] Some options listed below could add complexity for payers to determine whether the payee is exempt or the payment is reportable.
		  • Exempting transactions paid by merchant payment cards, such as credit cards. In August 2010, IRS issued a rule exempting payments reported under the new payment-card reporting requirements from 1099-MISC reporting.
		  • Delaying the effective date.
		  • Grandfathering ongoing relationships or specifying a lead time for collecting information on them.
		  • Issuing guidance to require that for business relationships just starting, TIN and information about services versus goods be provided immediately, for example on the invoice.
		  • Initially covering only specific payment types, such as rent payments to corporations.
		  • Extending existing exemptions for payments like freight, effectively exempting certain categories of corporations.
		  • Requiring reporting only for payments to some corporations, such as those privately held or below a certain size, for instance, smaller than the Fortune 500; exempt corporations could show their exemption on their invoices.[f]
		  • Raising the $600 floor for reporting (discussed above).
		  • Exempting small payer businesses from reporting based on their revenues or other factors; this option risks allowing noncompliance by some payees and gaming of the system. For example, a business may receive payments totaling $1 million with $200,000 of that reported to IRS by the nonexempt payers. If the business chooses to report only the $200,000 on its tax return, the IRS matching program would not be able to detect the $800,000 underreported.

Some payers find 1099-MISC submission burdensome/inconvenient.	

7. Some payers misreport or neglect to report payee taxpayer identification numbers (TINs) and could be subject to penalty and required to do backup withholding on 1099-MISC payments to payees with bad TINS.
Some payers misreport 1099-MISCs using the payee's partnership's name and TIN rather than the individual payee's Social Security Number (SSN).
	• Provide education and outreach activities to
	  • Remind payers to secure TINs from payees for 1099-MISC reporting to avoid backup withholding for missing or incorrect TINs.[g]
	  • Remind payers of IRS's voluntary TIN Matching program that allows authorized payers the opportunity to match payee TIN and name with IRS records free of charge before submitting the 1099-MISC.[h]
	  • Increase awareness of IRS policy on waiving incorrect or missing TIN information penalties and how a payer can establish reasonable cause.
	• Issue guidance to require that for business relationships just starting, TIN information be provided immediately, for example on the invoice.
	• Require payers to validate payee TINs (IRS, 2007).[i]
	  • Increase reporting burden for payers.
	  • Decrease number of 1099-MISCs unmatchable to payees for IRS's automated enforcement programs.

8. Payers submitting paper 1099-MISCs are required to use forms printed with special red ink scannable by IRS. IRS does not offer a fillable form for downloading on its Web site, and forms computer generated from accounting or tax software are not acceptable formats. Some payers submit black and white 1099-MISCs anyway.	• Provide an online portal for electronic submission similar to the Social Security Administration's portal for W-2s (ETAAC, 2007, 2008).[j]
	  • Potentially affects a majority of payers as 90 percent of payers used paper forms and 64 percent of all payers submitted one to four forms in 2006.
	  • Facilitate more accurate 1099-MISC entry and processing for IRS.
	  • Implementation has costs, and IRS currently has no plans for a 1099-MISC portal.
	• Allow payers to submit computer generated black and white 1099-MISCs (IRSAC, 2005).
	  • IRS currently has no plans to upgrade its scanning technology to eliminate the special red ink requirement and process computer-generated black and white 1099-MISCs.
	  • IRS submission processing officials said some black and white computer-generated forms are currently scanned but require additional work to ensure information was correctly scanned. These officials predicted that relaxing the red ink requirement would overwhelm the current scanning operation. In 2009, we reported that IRS had not conducted any research to determine the extent to which computer-generated black and white forms slows 1099-MISC processing.
	    • Lowering the 250 threshold for electronic submission would reduce the total number of paper submissions and might ameliorate such slowdown (ETAAC, 2007). Lowering the threshold would require legislative action.
	• Promote awareness of any offers for free electronic 1099-MISC submission services available through IRS's authorized e-file partners. (IRS)
	  • A few vendors in the past offered free online preparation and submission for small numbers of 1099-MISCs for businesses.[k]

9. Payers using IRS's Filing Information Returns System (FIRE) must register and buy software to format 1099-MISC data transmission, or pay a vendor to submit their forms electronically.	• Provide an online portal (discussed above). • Online portal likely to require registration with IRS and may be convenient for payers submitting a few forms, but not likely convenient for payers submitting 250 or more forms.

Source: GAO analysis, including that done in GAO-09-238 and GAO-08-266.

Notes:

[a]IRSAC, *Internal Revenue Service Advisory Council Public Meeting*, November 17, 2005 (Washington, D.C.: Nov. 17, 2005) and IRS, IRS Oversight Board, Annual Report 2007, (Washington, D.C.: March 2008).

[b]For example, the Form 1040 tax return instructions to help individuals determine whether they are required to file an income return. Also, the Schedule SE highlights who must file the schedule for self-employment tax and includes a chart to help individuals determine whether to file the short or long Schedule SE.

[c]In 2005 testimony, the National Taxpayer Advocate recommended reducing or eliminating the $600 threshold. In 2006, IRPAC recommended increasing the medical payment threshold to $5,000 to reduce payer reporting burden.

[d]GAO/GGD-91-118. In 1992, we recommended federal agencies issue information returns on payments to corporations (GAO/GGD-92-130). In 2004, we reported that revenues from extending reporting requirements to corporate payments could increase by billions of dollars (GAO-04-649). See GAO, *Tax Administration: Costs and Uses of Third Party Information Returns*, GAO-08-266 (Washington, D.C.: Nov. 20, 2007) for a list of how the additional costs payers would incur could be mitigated. GAO-09-238 included the matter for congressional consideration.

[e]The options are based on our previous analysis of 1099-MISC reporting requirements; we have not analyzed the costs and benefits of reporting payments for goods.

[f]To minimize burden on small businesses, the National Taxpayer Advocate recommended expanding 1099-MISC reporting to include corporations only if IRS's National Research Program (NRP) found significant levels of noncompliance among small corporations. *National Taxpayer Advocate, 2007 Annual Report to Congress, Vol. 1, Section Two—Key Legislative Recommendations*, (Washington, D.C.: Jan. 9, 2008). This phase-in approach does not simplify the need to track the payee's status.

[g]IRS Form W-9 can be used to obtain and certify the payee's tax identification number (TIN). IRS uses the combination of the payee name and TIN to match the information reported on a 1099-MISC with information reported by the payee on income tax returns.

[h]Currently TIN matching is only available to authorized payers that filed information returns with IRS in at least one of the two past tax years.

[i]Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, (Washington, D.C.: Aug. 2, 2007).

[j]The Social Security Administration offers free online submission of W-2s for payers submitting 20 or fewer forms.

[k]In 2007, we reported that, according to vendors we interviewed, prices for preparing and submitting 1099-MISCs were relatively low, ranging from about $10 per form for 5 forms to about $2 per form for 100 forms, with one of them charging about $0.80 per form for 100,000 forms. See GAO, Tax Administration: Costs and Uses of Third-Party Information Returns, GAO-08-266 (Washington, D.C.: Nov. 20, 2007).

As we reported in 2009, multiple approaches could help IRS to mitigate the reporting costs and promote payer compliance with 1099-MISC reporting requirements.[19] For example, the evidence shows that the benefits outweigh the costs for information reporting for payments to corporations. For other options, it is not clear whether the benefits outweigh the associated costs, and additional research by IRS could help to evaluate the feasibility of more costly options, such as allowing black and white paper 1099-MISCs. Action to move forward on options to target outreach to specific payer groups or clarify guidance to reduce common

[19]GAO-09-238.

reporting mistakes would hinge on IRS first conducting research to understand the magnitude of and reasons for payer noncompliance.

In 2009, we recommended two actions that IRS could take to help payers understand their 1099-MISC reporting responsibilities:[20]

- Provide payers with a chart to identify reportable payments. IRS disagreed with our recommendation and stated that the Form 1099-MISC instructions already list which payments are reportable and explain the rules for specific payment types. We believe that a chart would provide taxpayers with a quick guide for navigating the Form 1099-MISC instructions, already eight pages long under the current reporting requirements.

- Evaluate adding a new checkbox on business tax returns for payers to attest whether they submitted their 1099-MISCs as required. IRS also disagreed with this recommendation and stated that a similar question was removed from the corporate tax return after the Paperwork Reduction Act of 1980 was enacted. We believe results from the evaluation we recommend would be useful in weighing the benefits and burdens associated with a checkbox option.

To reduce the submission burden facing many payers submitting small numbers of 1099-MISCs, we also recommended that IRS evaluate the cost-effectiveness of eliminating or relaxing the red ink requirement to allow payers to submit computer-generated black and white 1099-MISCs. In April 2009, IRS conducted a test to determine the labor to process a sample of 4,027 red-ink 1099-MISCs versus the same documents photocopied. IRS told us that, using the same scanning equipment and employees, the red-ink sample took 2 hours and 9 minutes to process versus 28 hours and 44 minutes to process and manually key the photocopy sample. Based on the test results, IRS decided to maintain the red ink requirement to minimize labor costs. We have not reviewed the results of the IRS test.

Our prior work did not assess requiring 1099-MISC reporting on payments for goods. Some of our findings and recommendations may be relevant, but we do not know the extent of relevance.

[20]IRS has taken action to implement a third recommendation—to add a 1099-MISC reporting reminder to *Publication 535 Business Expenses*.

Madam Chair, this concludes my statement. I would be pleased to respond to any questions you or other Members of the Committee may have.

GAO Contacts and Acknowledgments

For questions about this statement, 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 statement. Individuals who made key contributions to this testimony include Amy Bowser, Bertha Dong, Lawrence Korb, MaryLynn Sergent, and Cheri Truett.

Related GAO Products

Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements. GAO-09-238. Washington, D.C.: January 28, 2009.

Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance. GAO-08-956. Washington, D.C.: August 28, 2008.

Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential. GAO-08-703SP. Washington, D.C.: June 2008.

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Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed. GAO-06-603. Washington, D.C.: June 13, 2006.

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Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts. GAO-03-378. Washington, D.C.: January 31, 2003.

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