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SOCIAL SECURITY

Reconciliation Improved SSA Earnings Records, but Efforts Were Incomplete



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The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

The Honorable Andrew Jacobs, Jr.
Chairman, Subcommittee on Social Security
Committee on Ways and Means
House of Representatives

This report responds to your request that we review the progress made by the Social Security Administration (SSA) and the Internal Revenue Service (IRS) in addressing a problem affecting the accuracy of SSA's earnings records. After our 1987 report on this matter, SSA and IRS formally agreed to take actions to improve the wage-reporting process and contact employers in an attempt to obtain either (1) wage information that SSA was missing or (2) information that explained why the filed wage reports were correct.

This report contains recommendations to the Commissioners of Social Security and Internal Revenue to further improve the wage-reporting and reconciliation process. In addition, it suggests that the Congress consider amending the funding process established in section 201(a) of the Social Security Act.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time we will send copies to the Commissioners of Social Security and Internal Revenue, the Secretaries of Health and Human Services and the Treasury, other congressional committees with jurisdictional interests in social security and taxation issues, and make copies available to other interested parties.

Major contributors to this report are listed in appendix IV. If you have any questions, please call me at (202) 512-7215.

Joseph F. Delfico
Director, Income Security Issues

Executive Summary

Purpose

In a 1987 report, GAO stated that employers had reported over \$58 billion more in social security wages to the Internal Revenue Service (IRS) for tax payment purposes than to the Social Security Administration (SSA) for social security purposes. This meant that (1) millions of workers' earnings records—used for calculating their social security benefits—were not credited for wages they had earned and paid social security taxes on, and (2) billions of dollars provisionally credited by Treasury to the social security trust funds were not supported by SSA's records, as provided by law. The House Ways and Means Committee and its Subcommittee on Social Security asked GAO to report on the progress made by SSA and IRS in resolving the differences in the wages reported to them.

Background

Accurate earnings records are critical to the social security retirement, survivors, and disability insurance programs. Workers' earnings records are used to determine their average lifetime earnings and the benefits to which they will be entitled. Also, the Social Security Act requires Treasury to credit revenues to the trust funds by applying the tax rate to wages certified by SSA as recorded in SSA records.

The accuracy of SSA records became a concern in 1978 following the establishment of a combined annual wage-reporting process that required employers to separately report wages to SSA and IRS. SSA receives annual worker wage data for its records on form W-2. From each employer, IRS receives quarterly aggregate wage data on form 941. With these data, it can determine if the employers accurately and promptly deposited income and social security taxes withheld from their employees' wages as well as the employers' share of the social security tax.

In 1978, the agencies established a formal Memorandum of Understanding (MOU) to share wage data. IRS uses SSA's W-2 wage data to determine if each person properly reports their income on tax returns. SSA uses IRS's 941 aggregate wage data to determine whether employers reported all of their workers' wages on which social security taxes were paid.

Through these comparisons, SSA and IRS discovered that significant differences existed in many employers' wage reports. But SSA and IRS disagreed about who was responsible for contacting the employers to reconcile the differences and obtain missing reports. Recognizing a large shortfall in reported social security earnings, SSA became concerned about the completeness of its earnings records and started to certify wages on a provisional basis, using the wage data reported to IRS as a supplement to

its own. However, little was done by either agency to reconcile the reporting differences.

Following GAO's 1987 report, SSA and IRS revised the MOU to clarify their roles and responsibilities in addressing the reported wage differences. SSA first looks for missing or erroneous W-2s. If it cannot explain the difference, it sends a letter, and if needed one follow-up letter, to employers asking them to explain the difference and submit wage reports needed to correct the reported difference. Beginning with tax year 1987, SSA refers to IRS all cases in which employers did not respond to its reconciliation letters or the letters were returned undelivered. IRS then writes employers requiring them to resolve the wage-reporting problems or face a tax-filing penalty. Additionally, IRS is to take certain administrative actions to prevent future differences.

Results in Brief

Considerable progress has been made in addressing the differences between wages reported to SSA and IRS. In over 6 million cases, SSA has tried to contact employers and more than \$44 billion of the \$109 billion in earnings differences have been reduced for tax years 1978-86. Through such contacts, SSA has been able to correct millions of workers' social security records, reducing the chances that individuals' benefits will be affected by missing wage reports. Now that SSA has begun working the more recent 1987-89 cases, fewer of its letters go undelivered and employer response rates have improved. SSA has referred the unreconciled cases to IRS for tax years 1987-89, and IRS has begun to contact these employers. Its efforts have helped SSA to correct additional workers' records.

However, the reconciliation process would have been more successful had IRS met all of its MOU commitments. Its delays in establishing a penalty program caused IRS to overrun a statute of limitations on using such penalties. Thus, it could not penalize all employers who did not respond to its letters. IRS did not effectively institute MOU provisions to help prevent known causes of reporting differences and arbitrarily limited the number of referred SSA cases that it worked. In addition, SSA needs to do more to prevent employer reporting problems.

Also unresolved is the trust fund problem arising from differences in SSA and IRS records. After reconciliation, over \$65 billion in wage differences remain for 1978-86 cases. Thus, about \$9 billion credited to the trust funds—social security taxes on the unreconciled wages—are not

supported by SSA's earnings records. Given various options for resolving this matter, GAO concluded that funding of the trust funds should be based on the amount of social security taxes collected.

Principal Findings

Progress Has Been Made

SSA and IRS have made reconciliation of differences in employer wage reports a regular part of their work loads. Where once these types of cases were not worked, today SSA and IRS routinely contact employers to reconcile the wage differences. For tax year 1978-86 cases, these contacts have produced over 29 million W-2s, and SSA has reduced its differences with IRS records from \$109 billion to \$65 billion.

Unresolved differences remain high, particularly in the older cases, because employers often are no longer in business or lack records needed to resolve the differences. As SSA works more current cases, fewer reconciliation letters go undelivered (for example, about 27 percent for 1978 versus about 6 percent in 1988) and the rate of employer responses has increased (44 percent for tax year 1978 versus about 59 percent in tax year 1989). In cases referred to IRS, the IRS contacts are producing W-2s for SSA, although the numbers have not been recorded. (See pp. 14-19.)

IRS Did Not Meet MOU Commitments

IRS did not fully meet several of its commitments. First, IRS was late in establishing a program to assess penalties on nonresponding employers. The penalty provision was included in the MOU to (1) encourage greater care by employers when preparing wage reports for future years and (2) obtain more W-2s, because IRS often finds employers supply W-2s after they are penalized. Due to the delays, IRS was precluded by a statute of limitations from penalizing thousands of employers for not filing required wage reports. (See p. 19.)

Also, contrary to the MOU, IRS has not promulgated regulations requiring employers to file W-2s for their employees within 30 days of terminating operations, an action to address a known cause of reporting differences. Some employers who go out of business in the middle of the tax year file quarterly tax returns with IRS, but do not file W-2s at the end of the tax year with SSA. (See p. 20.)

IRS revised the form W-3, which transmits and summarizes certain wage data on the W-2s filed with SSA, to require employers to report the total amount of wages reported to IRS for the tax year on the quarterly 941s. This was supposed to lead to employers spotting and correcting differences before the reports were filed with SSA. But, IRS instructions for the revision were unclear and the change was ineffective. IRS has revised its instructions for tax year 1992. (See p. 21.)

To reduce its reconciliation costs, IRS established a policy of only assessing penalties on nonresponding employers when a minimum penalty threshold was met. This was not in accord with the MOU and reduces the number of SSA-referred cases that IRS penalizes. (See p. 20.)

IRS Should Pursue Undelivered Cases

IRS does not attempt to reconcile referred cases where SSA had letters returned to it as undelivered, because it believed its letters also would be undelivered. However, in about 30 percent of a judgmental sample of such cases, IRS had a different address than SSA used, giving IRS a further avenue to pursue needed wage information. (See p. 21.)

SSA Can Do More to Prevent Employer Reporting Problems

Employers are making many types of preventable wage-reporting errors, such as failing to report social security numbers and names on W-2s and reporting social security wages incorrectly. Employers have advised SSA that they need better reporting instructions and assistance with problems before they file reports. SSA needs to place greater emphasis on preventing reporting problems. (See p. 22.)

Trust Fund Accounting Issue Is Unresolved

Social security trust funds are being routinely credited with tax dollars that are not supported by SSA's wage records. According to SSA records, even though reconciliation efforts for tax years 1978-86 are complete, over \$65 billion in differences between IRS and SSA records remain. As a result, more than \$9 billion currently credited to the trust funds is not supported by SSA's records under the funding scheme established by the Social Security Act. The Congress should consider amending the act so that credits to the trust funds are based on the amount of social security tax revenues collected. This funding approach best matches trust funds with actual revenues collected and is consistent with program principles. (See pp. 27-31.)

Recommendations

GAO recommends that IRS fully meet its commitments under its MOU with SSA and that IRS and SSA amend the MOU to ensure that reasonable efforts are made to contact employers in undelivered cases. Finally, GAO recommends that SSA examine the clarity of wage-reporting instructions and consider how it can better respond to employer questions. (See p. 24.)

Matters for Consideration

GAO suggests that the Congress consider revising section 201(a) of the Social Security Act to provide that the trust funds receive revenue based on the amount of social security taxes collected each year. (See p. 30.)

Agency Comments

Both SSA and IRS expressed their overall agreement with this report's recommendations. SSA, however, believes that action to resolve the trust fund accounting issue while it and IRS are considering changes in the wage-reporting process would be premature. GAO continues to believe that congressional consideration of this matter is warranted. (See pp. 25, 26, 30, and 31.)

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Abbreviations

GAO	General Accounting Office
IRS	Internal Revenue Service
MOU	Memorandum of Understanding
SSA	Social Security Administration

Introduction

In 1987, we reported on significant differences (over \$58 billion) in the amount of wages reported by employers to the Social Security Administration (SSA) and the Internal Revenue Service (IRS).¹ The differences in reported wages had particularly significant implications for the social security entitlement programs (retirement, survivors, and disability insurance). The differences indicated that SSA was missing wage reports for millions of workers. This situation raised questions about the accuracy and completeness of SSA's earnings records, which are used to determine both a person's benefit amount and the amount of revenues owed to the trust funds that finance the programs.

Since then, SSA and IRS have worked to reconcile the wage-reporting differences. At the request of the House Committee on Ways and Means and its Subcommittee on Social Security, we evaluated the actions taken by SSA and IRS and obtained information on how SSA's earnings records have been affected.

Wage Reporting and Its Importance to Social Security Programs

Each year, millions of employers file reports with SSA and IRS on the wages they have paid to their employees. Employers file with SSA over 200 million form W-2s—the Annual Statement of Wages and Taxes, showing for each employee wages paid the previous tax year. In addition, with IRS, employers file quarterly wage reports on form 941. This is the Employer's Quarterly Federal Tax Return, which shows the aggregate amounts of wages an employer paid to all its employees during the quarter and amounts withheld for income and social security taxes.

These wage reports are critical to the operations of each agency. SSA uses the W-2 to credit workers' earnings to their social security accounts, which are later used as a basis to calculate social security program benefits. IRS uses form 941 to ensure the prompt and correct deposit of employment taxes (income and social security taxes withheld from employees and the employers' share of the social security tax) to Treasury.

SSA provides its W-2 information to IRS, which uses it to ensure that (1) individuals accurately report their income on their tax returns and (2) employers report and pay the appropriate amount of income and social security taxes. Likewise, IRS provides SSA with form 941 information, which SSA uses to ensure that (1) it has received W-2s from all employers who reported that they withheld social security taxes and (2) the aggregate

¹Social Security: More Must Be Done to Credit Earnings to Individuals' Accounts (GAO/HRD-87-52, Sept. 18, 1987).

amount of social security wages reported on the W-2s are equal to the aggregate amount of social security wages reported on form 941 for each employer.

The Wage-Reporting Problem and Its Implications

Compared with the total amount of wages reported to IRS for tax years 1978-84, SSA had (as of March 1987) about \$58.5 billion less in wage reports. An average of 650,000 employers each year had reported more wages to IRS than to SSA. In another 500,000 cases more wages were reported to SSA than to IRS.

For about 70 percent of these employers, SSA had no W-2s (referred to as missing cases). In the remaining cases, the employers had reported less in social security wages to SSA than to IRS (referred to as discrepant cases). This meant that an unknown number of employees had missing earnings from their social security records, which could ultimately affect their benefits under the social security programs.

The problem also had a significant effect on the amount of money available to pay program benefits and administrative costs. Since 1950, the Social Security Act has required that social security tax revenues be transferred from general revenues to the social security trust funds on the basis of wages certified by the Secretary of Health and Human Services as entered in SSA's records.² Treasury then applies the appropriate tax rate to the certified amounts to establish the tax revenues owed to the trust funds for the period.

With the significant difference between SSA and IRS records, SSA became concerned about the completeness of its earnings records. It ceased making unequivocal certifications and began to make "provisional" certifications, using IRS wage data to supplement its own records. As a result, for tax years 1978-86, about \$9 billion have been credited to the trust funds that are not supported by SSA records, as the law requires. Additional billions of dollars have been credited for subsequent years as well.

Response to Our Report

Our report led to congressional hearings on the problem in October 1987. In July 1988, SSA and IRS revised their formal agreement, the Memorandum of Understanding (MOU), which governs management of the wage-reporting

²In practice, SSA certifies on behalf of the Secretary of Health and Human Services.

process. The revisions detailed each agency's duties and responsibilities for addressing the differences in wage reports.

Basically, SSA agreed to make all reconciliation efforts for the cases that accumulated from 1978 to 1986. Beginning with tax year 1987 cases, SSA agreed to make the initial efforts to contact employers to solicit necessary information for resolution. Any employer report that SSA could not resolve was to be referred to IRS.

In the referred cases, IRS was to contact employers again to request information needed to resolve the difference in reports. IRS's letter warned employers that if they failed to resolve the reporting differences, they would be penalized for failing to file required tax information.

Additionally, IRS was to make certain administrative changes to wage-reporting requirements to reduce the number of reconciliation cases each year. These changes included (1) revising regulations to require employers terminating business operations to file W-2s within 30 days of termination rather than by February 28 of the following year and (2) requiring employers to report to SSA the amount of social security wages reported on its 941 reports to IRS.

Objectives, Scope, and Methodology

The objectives of this review were to assess the progress made by SSA and IRS in resolving wage-reporting differences and to offer suggestions to improve the wage and trust fund crediting procedures. Specifically, the Chairmen of the House Committee on Ways and Means and its Subcommittee on Social Security requested that we

- describe actions taken by SSA and IRS under the MOU and evaluate their adequacy,
- determine whether SSA and IRS have lived up to the commitments they made in the MOU,
- analyze the outcome of the reconciliation efforts (in particular, determine how much new wage data SSA was able to obtain from the reconciliation effort), and
- make recommendations for further improvements to the wage-crediting process.

Our review concentrated on efforts by SSA and IRS to reconcile the difference in reported wages for tax years 1978-88. We interviewed SSA and IRS headquarters officials concerned with: (1) MOU implementation, (2) the

wage-reporting process, and (3) the penalty assessment program. This work was performed in Baltimore and Washington, D.C.

We reviewed each agency's reconciliation procedures and reconciliation management reports. We visited several organizations tasked with carrying out the reconciliation efforts located in SSA's Office of Central Records Operations in Baltimore and IRS's Service Centers in Philadelphia, Pennsylvania and Brookhaven, New York.

Our work was done between March and November 1991. Statistics presented in this report were obtained from SSA and IRS management information systems developed to control the reconciliation process. We checked the data for consistency, but did not review the controls over the systems that produced it. In all other aspects, our work was carried out in accordance with generally accepted government auditing standards.

Substantial Progress Made, but Further Improvements in Reconciliation and Wage-Reporting Process Needed

The Social Security Administration and the Internal Revenue Service have made substantial progress in addressing the wage-reporting problem discussed in our 1987 report. Both agencies have established a formal process to routinely contact employers who report less wages to SSA than to IRS. For tax years 1978 to 1986, these efforts have produced over 29 million additional wage reports for SSA and reduced the differences with IRS wage records by about \$44 billion. Despite the progress, several of the planned corrective actions were not implemented and more can be done to prevent wage-reporting problems.

Results of the Reconciliation Process

The reconciliation process has resulted in a substantial number of successful contacts with employers, significant increases in receipts of W-2s, and although not precisely measurable, improvements in workers' earnings records. SSA in particular has worked diligently on this problem. It has sent employers over 6 million letters seeking information about reporting differences and received responses in about 3 million cases.

In addition, with the completion of reconciliation efforts on the older backlogged cases (1978-86), SSA now is contacting employers about much more recent differences in the wage reports filed with SSA and IRS. The increased timeliness of contacts as SSA works cases on a more current basis is improving the results of the process, as table 2.1 shows.

Table 2.1: SSA Reconciliation Letters Sent and Responses Received for Tax Years 1978-89

Letters sent and received in thousands

Year	Letters sent	Letters received	Percent
1978	502.7	221.6	44.1
1979	619.9	259.9	41.9
1980	524.3	215.8	41.2
1981	446.1	183.7	39.4
1982	485.2	204.1	42.1
1983	566.7	298.5	52.7
1984	612.1	299.3	48.9
1985	613.8	318.8	51.9
1986	609.1	329.6	54.1
1987	480.8	309.9	64.5
1988	538.1	363.4	67.5
1989	484.1	285.9	59.1

Note: Letters sent as a second mailing to employers are not included.

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Precisely measuring the impact of this massive effort on SSA's earnings records is not possible. SSA only broadly monitors the nature of employer responses. It cannot identify the actual amount of new wage data it posted or the number of workers' accounts that were credited with additional earnings. Nevertheless, there are strong indications that substantial amounts of new wage information were obtained through reconciliation.

For example, for tax years 1978-89 employers contacted by SSA through the reconciliation process have submitted over 42 million W-2s. Almost 13 million of these were for cases where SSA previously had received no wage reports from the employers. Most, if not all, of these reported wages probably represent new wages recorded in SSA's earnings records.

The remaining 29 million W-2s were for discrepant cases. In these cases, SSA believes employers often sent in wage reports for all of their employees because the employers did not know which workers' wages may not have been previously reported. This type of submission would duplicate much of the wage data SSA already had recorded, but it is reasonable to assume that these reports included some new data, which SSA posted to its records.¹

The total dollar impact of these wage reports on SSA's records can be gauged, however, by examining the difference between SSA and IRS records before reconciliation efforts began and after. For the tax years where all reconciliation efforts are complete (1978-86), the difference narrowed from about \$109 billion to \$65 billion, as shown in table 2.2.²

¹SSA has edit controls to prevent duplicate wage reports from being improperly credited.

²SSA is constantly receiving and processing wage reports for its earnings records. Thus, it is likely that some part of this reduction in earnings differences with IRS records is not attributable to reconciliation. However, reconciliation was the most significant wage-record activity occurring during this period and is likely to be the primary source of new data for SSA's earnings records.

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Table 2.2: Employer-Reported Wage Differences Before and After SSA Reconciliation

Dollars in billions

Year	Wage difference		Amount reconciled
	Before reconciliation	After reconciliation	
1978	\$ 3.8	\$ 3.3	\$ 0.5
1979	2.5	2.3	0.2
1980	7.7	5.2	2.5
1981	0.3	(1.0) ^a	1.3
1982	8.3	6.6	1.7
1983	11.1	7.9	3.2
1984	24.8	10.7	14.1
1985	18.7	11.9	6.8
1986	32.0	18.6	13.4
Total	\$109.2	\$65.5	\$43.7

^aAfter reconciliation, SSA records now show greater amounts than IRS records.

As mentioned earlier, another significant aspect of the reconciliation process is that with the completion of reconciliation efforts for the backlog cases, SSA is reconciling wage reports on a more current basis. As it identifies and attempts to reconcile wage-report differences sooner, its success rates for letters delivered, responses received, and numbers of individual wage reports provided by employers have increased (see figs. 2.1 and 2.2). These trends are also reflected in the increasing case resolution rate, as shown in figure 2.3.

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Figure 2.1: Delivery and Response Rates for SSA Reconciliation Notices (1978-88)

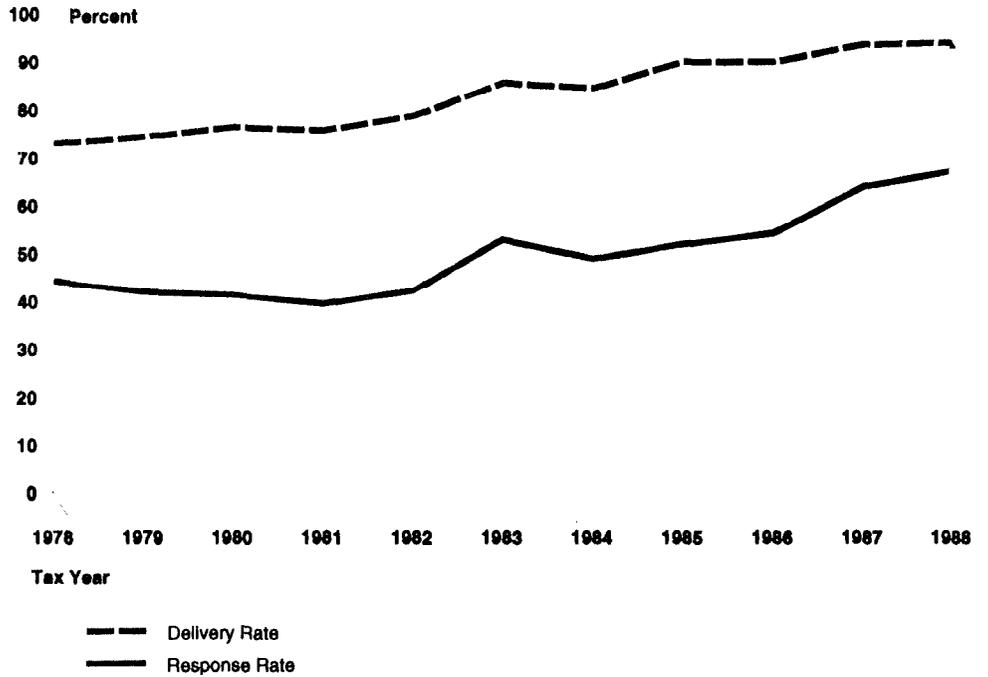
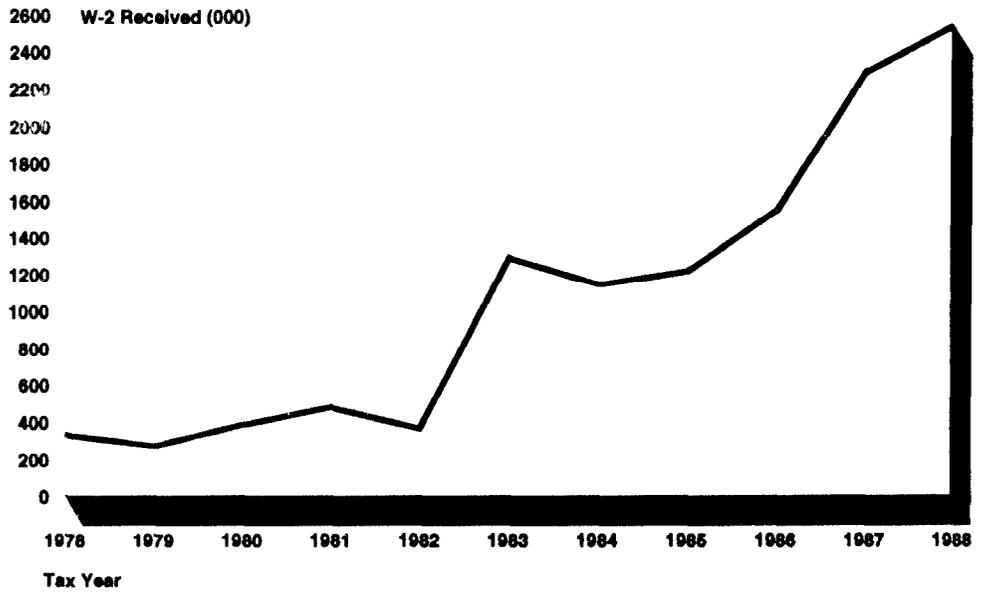
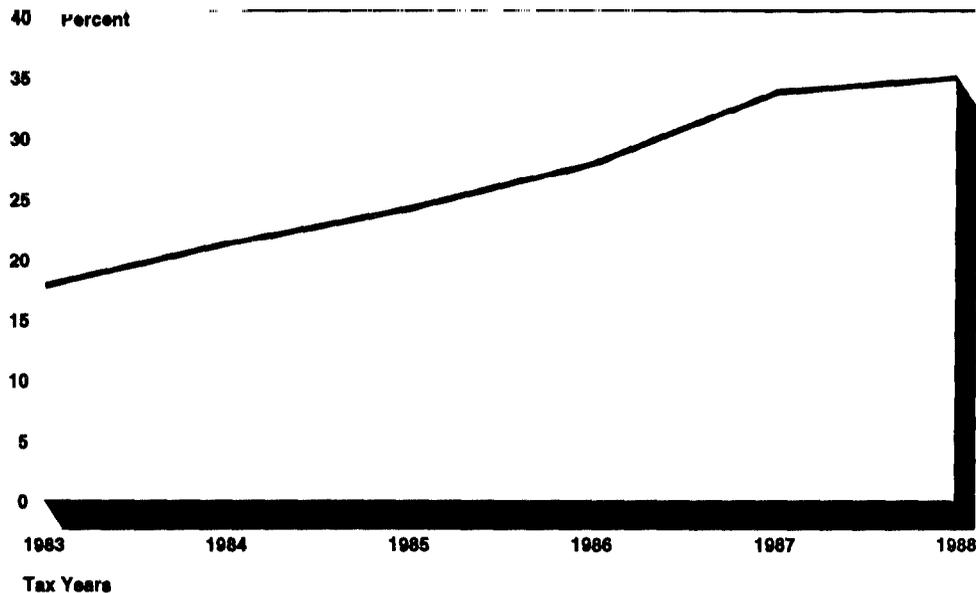


Figure 2.2: Number of New W-2s Received in Missing Reconciliation Cases (Tax Years 1978-88)



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Figure 2.3: Percent of Cases Resolved
by W-2 Submissions, by Tax Year
(1983-88)



Note: The percent of resolved cases for tax year 1983 is an average of the number of W-2s received from 1978-83. Detailed figures on annual W-2 receipts for these years are not available.

IRS became involved with nontax related reconciliation in December 1989 when SSA began referring unreconciled tax year 1987 cases under the Memorandum of Understanding provisions. Since then, IRS has begun contacting employers and assessing penalties against those who do not respond to its inquiries.

In these cases, IRS has kept very limited management information on the results of its efforts. Table 2.3 shows the number of employers who responded to IRS reconciliation contacts. Many of these responses included additional W-2s that either completely or partially resolved the reconciliation problem. However, IRS did not maintain a detailed accounting of the number or value of W-2s received.

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**Table 2.3: Results of IRS
Reconciliation Work (Tax Years 1987-
88)**

Year	Letters sent	Employer submissions ^a	
		Before assessment	After assessment
1987	191,653	42,215	11,113
1988	104,920	23,320	10,811

^aBased on IRS data as of December 31, 1991.

**IRS Did Not Meet All
of Its MOU
Commitments**

IRS did not fulfill all of the commitments it made in the MOU. IRS was late in establishing a penalty assessment program; it established a tolerance that reduced the number of referred SSA cases that it had agreed to reconcile and did not successfully implement administrative actions designed to reduce the number of employer reports needing reconciliation. These actions reduced the potential success of the reconciliation program.

**Penalty Assessments Not
Timely**

The MOU called for IRS to assess penalties against employers who failed to respond to reconciliation notices sent by both SSA and IRS. The intent of the penalty assessment provision was to encourage employers to submit corrected or new wage reports being sought and to exercise more care when preparing future wage reports to avoid being penalized again.

In December 1989, SSA began referring to IRS lists of employers who had not responded to its reconciliation letters for tax year 1987 cases. In accordance with the MOU, IRS began sending notices to employers in the referred cases in March 1990. IRS mailed its reconciliation notices over a 10-week period and requested a response within 45 days. In June 1990, IRS began to assess penalties against the employers who did not respond to its notices. However, soon after the penalty assessments began, IRS identified programming errors that affected the calculation of the penalties and its ability to process the assessments. IRS stopped making penalty assessments while it corrected the problem and reversed assessments it previously made.

As the programming errors were being addressed, some IRS field offices expressed concern about the effect of these penalty assessments on IRS's accounts receivable inventory. Some IRS officials feared that many of the assessments would be uncollectible because they presumably involved defunct businesses. These IRS officials questioned the wisdom of creating additional accounts receivable when the agency was already being widely

criticized by the Congress and in the press for the size of its accounts receivable inventory and its inability to collect much of this debt.

IRS corrected the programming problems in late 1990. However, the internal organizational concerns about the effects of these assessments on the accounts receivable inventory remained unresolved. In May 1991, IRS decided to proceed with assessing the penalties agreed to under the MOU. The delay in reaching a decision over these internal concerns, however, allowed a statute of limitations on the use of civil penalties to take effect. This statute precludes IRS from assessing a civil penalty for the late or nonfiling of wage reports after 3 years have elapsed from the date the employer filed any W-2s or W-3s.

For the 1987 cases referred by SSA, this meant that IRS had to make a penalty assessment against nonresponding employers by no later than February 28, 1991. Therefore, about 30,000 SSA-referred discrepant cases could not be penalized by IRS in accordance with the requirements of the MOU. The statute did not affect SSA-referred missing cases because employers had not yet filed any W-2s.

Other Referred Cases Not Worked

IRS sent reconciliation notices to all employers who failed to respond to SSA's earlier inquiries. However, IRS failed to comply with the MOU when it did not penalize nonresponding employers in certain cases. IRS became concerned about the cost and benefits of assessing penalties in cases where small differences existed in wage reports. Thus, IRS established a tolerance that precluded penalizing nonresponding employers unless the penalty exceeded a predetermined amount.

IRS did not track the number of SSA-referred cases that were affected by the tolerance. In assessing the effects of this policy, we found that employers often respond to reconciliation requests after they are assessed a penalty. Thus, by using a penalty tolerance, IRS effectively reduced the chances of SSA receiving wage reports to improve the accuracy and completeness of some individuals' earnings records.

IRS Failed to Revise W-2 Filing Requirements

Employers are required to report each of their employees' earnings for the previous calendar year to SSA on form W-2 by February 28. SSA and IRS learned that one cause of wage-reporting problems was related to employers going out of business in the middle of the tax year. This situation sometimes resulted in employers filing one or more quarterly

941s with IRS, but no W-2s with SSA, as they had terminated their business operations months before the February filing date. To address the problem, IRS and SSA agreed to change reporting regulations to have employers file W-2s with SSA within 30 days after terminating business operations.

As IRS issues regulations governing the filing of form W-2, its Office of the Chief Counsel agreed to take on the project. However, since the agreement was made in July 1988, no efforts had been made, as of January 1992, to draft the proposed regulatory changes. IRS stated that the matter is a low priority relative to the many other regulatory projects pending action. No time frame has been set to effectuate the change.

Revisions to Form W-3 Unsuccessful

SSA and IRS also agreed to revise form W-3 (Transmittal of Income and Tax Statements) to provide a space for employers to enter the applicable total money amounts related to their 941 returns. Form W-3 accompanies the filing of an employer's W-2s to SSA and aggregates various information reported in detail on the W-2s for the tax year. It was hoped that this change would highlight for employers when social security wages reported on their 941 and W-2 reports did not match. Through instructions, employers would be advised to correct reports to avoid later reconciliation contact and possible penalty.

IRS revised form W-3 for tax year 1990, providing a space for employers to report "adjusted total social security wages and tips." Instructions told employers that the amounts reported in this box should agree with the social security wages and tips reported on forms 941. However, the instructions associated with the new information were not clear.

At a wage-reporting conference sponsored by SSA, payroll managers expressed confusion about what information was to be reported in the new space. They told SSA and IRS officials that they considered the instructions vague and confusing, and they suggested ways to improve the instructions. Agreeing that improvements were needed, IRS revised the instructions for tax year 1992.

Undelivered SSA-Referred Cases Need More Work

Beginning with tax year 1987, SSA referred to IRS all reconciliation cases it could not resolve. The referrals included cases where the Postal Service had returned to SSA its reconciliation letters because they were not

deliverable to the employer's listed address. IRS did not attempt to reconcile any of these cases (about 30,000 each tax year).

The MOU does not explicitly cover how undelivered cases will be handled. One SSA official told us that the MOU says that SSA will refer all unreconciled cases. He believed that because undelivered letters were unreconciled, IRS was to attempt to resolve the differences. However, an IRS official disagreed. He said that during negotiations about IRS's role in reconciling the SSA cases, it was understood by both agencies that IRS would not work undelivered cases because of their low potential for success.

For tax year 1988, we judgementally sampled 50 undelivered cases to determine whether IRS had a different address than used by SSA. The difference in reported amounts to the two agencies was at least \$50,000. In 30 percent of the cases, IRS had a different address than SSA used. And in several instances, it appeared the employer was still filing tax returns with IRS. In most of these cases, however, the IRS address appeared to be that of an agent designated to handle the affairs of an inactive company. In either situation, the different address available to IRS provides another avenue to pursue the wage information needed to correct SSA earnings records.

Preventing Employer Reporting Problems

Because employers prepare and submit the wage reports SSA uses, they are crucial to the administration of the social security programs. For SSA to receive quality wage reports, employers need to understand (1) regulations on wages, which can be complex; (2) reporting requirements; and (3) the relationship among various wage reports they must file. There is considerable evidence, however, that employers often do not clearly understand these elements of the wage-reporting process.

For example, in 1990, SSA reported on its study of employer responses to its reconciliation letters for tax years 1978-84. To identify causes of reporting differences, SSA examined about 250 employer responses. Many of the errors it found were attributed to such employer mistakes as follows:

- Reporting as social security wages certain types of payments not subject to the tax (for example, educational allowances, mileage, per diem travel, and amounts in excess of the taxable wage ceiling).
- Reporting taxes withheld in the wage field on the W-2 .
- Reducing the social security wage reporting by the amount of social security tax withheld from their wages.

- Failing to file W-2s when employers lacked forms or where missing information, such as an employee's social security number (particularly true in household employer situations).

There are numerous other indications of employer confusion over wage reporting. Every year, about 750,000 employers submit annual wage reports to SSA on magnetic media and SSA rejects thousands of these reports because correct filing procedures were not followed, making the data submitted unusable. The rejections cost SSA millions of dollars annually and may cause employers to suffer penalties imposed by IRS. Further, each year SSA is unable to post earnings for over 1 million wage reports to individuals' records because the reports lack identification information (name and/or social security numbers) needed to credit the earnings.

Information as to why employers make these types of reporting errors is not available. Comments from payroll managers indicate that basic deficiencies with how the government communicates with employers on wage reporting may be a significant cause.

For example, on several occasions the American Society of Payroll Management³ has expressed concerns about the wage-reporting instructions. It has complained to SSA and IRS about inadequate instructions for correcting reports and lack of clarity on such subjects as the revision of form W-3 (previously discussed), and has pointed to instructions for form W-2 that are incomplete and misleading. Additionally, it has said that untimely communication of changes in reporting requirements hamper employers in their efforts to change and test payroll software used to prepare wage reports. It also advised SSA about difficulties in obtaining answers to reporting questions.

SSA has many organizational components that play a role in the wage-reporting process, but no focal point to coordinate all of their various efforts. Components in its Office of Systems prepare and communicate instructions for reporting on magnetic media. SSA's Office of Programs reviews and helps prepare wage-reporting instructions issued by IRS. Its Office of Central Records handles employer contacts generated by reconciliation. The comments of the payroll groups reflects their experience with this operational environment.

³A payroll advocacy group whose more than 300 members consist of companies in the private sector, accounting firms, and various components of local governments.

From a program administration perspective, it is in SSA's interest to reduce employer reporting errors. Because much of the wage-recording process is automated, SSA estimates that it costs an average of 31 cents to process and post each wage report it receives through the annual wage-reporting process. In contrast, when SSA has to correct wage reports, more manual effort is needed. SSA estimates that it costs \$265 to investigate and correct an error in a person's earnings record.

Conclusions

Wage reconciliation efforts by SSA and IRS have reduced the net difference between the two agencies' records by about \$44 billion. Still, over \$65 billion in differences remain. It is unrealistic to expect that their records will ever be in complete agreement, given their reliance on millions of employer's reports and the complexity of wage reporting and tax administration. However, further reductions in the amount of reported differences appear possible with improvements to the reconciliation process and increased emphasis on preventing employer wage-reporting errors.

Recommendations to the Commissioners of Internal Revenue and Social Security

We recommend that the Commissioners of Internal Revenue and Social Security take the following actions to improve the process for reconciling differences in wage reports and employer reporting accuracy.

- IRS should comply with all agreed-upon provisions of the MOU. It should contact all employers in cases referred by SSA under the terms of the MOU, eliminate any penalty tolerance that is not in accord with the MOU, and take prompt action to issue regulations to mandate the filing of W-2s within 30 days after a business terminates operations.
- SSA and IRS should amend the MOU to ensure that reasonable efforts are made to contact employers whenever SSA does not have its reconciliation letters delivered.
- SSA should place more emphasis on identifying and addressing causes of employer problems in reporting wages. It should examine the clarity to its wage-reporting instructions and consider how it can better respond to employer wage-reporting questions, such as by providing a single contact point for employers.

Agency Comments and Our Evaluation

SSA and IRS formally commented on this report by letters dated July 15, 1992, and July 16, 1992, respectively (see apps. II and III). Both agencies expressed overall agreement with the report and its recommendations.

Each addressed the recommendations directed to them and discussed actions they either are taking or are planning to take in reconciling wages.

**Working Cases With
Undeliverable
Reconciliation Letters**

SSA said that it is currently negotiating with IRS to amend the MOU to provide that IRS will review its employer address files to determine whether further efforts to contact employers that SSA could not reach are warranted. IRS stated that, beginning with tax year 1991, it has agreed to work undeliverable reconciliation cases whenever it has a different address than the one used by SSA. Such action would accomplish the intent of our recommendation.

**Improving Employer
Reporting Accuracy**

SSA agreed that it should place more emphasis on identifying and addressing causes of employer problems in reporting wages. Acknowledging that many of its organizational components play a role in the wage-reporting process, SSA listed a variety of actions it has taken over the years (some directly related to the topic of employer reporting, others directed more at helping individuals improve the accuracy of their earnings records). SSA said that it will consider the appropriateness of developing a formal organizational structure to perform this function.

SSA also said that many reconciliation cases result from the different reporting dates for the form 941 (January 31) and the W-2s and W-3s (February 28). The difference in filing dates results in some employers failing to ensure that the total of the two forms are the same. We are not aware of any data identifying the extent of this matter as a cause of reconciliation problems. Like the timely filing of W-2s for businesses terminating operations, the timing of these reports could be adjusted and commitments to make these changes recognized in the MOU.

IRS also pointed to a number of revisions it has made to various forms and instructions for wage reporting. IRS said that it has revised the 1992 form W-3 instructions to clarify how employers should reconcile the adjusted total of social security wages and tips on the form W-3 with the amounts reported to IRS or their quarterly tax returns. In addition, IRS said that Circular E (Employer's Tax Guide) and instructions for Form W-2 contain a more detailed discussion on reducing differences in wage amounts separately reported to SSA and IRS. It also said that it will continue to work with SSA to further clarify the guidance in the instructions for 1993.

**Eliminating Tolerance Not
Covered by the MOU**

While recognizing that the MOU does not specifically address the use of penalty tolerances for this program, IRS said that the tolerances used are quite low. IRS indicated that it would like to continue the use of such a tolerance, saying that it is willing to negotiate tolerance amounts with SSA.

We view the penalty assessment provision of the MOU as a critical aspect of the reconciliation program. Its purpose was to provide employers with an incentive to (1) provide SSA with information or wage reports that reconciled differences with IRS records for the tax year in question and (2) encourage greater care by employers when filing wage reports for future tax years.

When we reviewed IRS reconciliation efforts for SSA-referred cases, staff told us that employers often responded only after a penalty was assessed. Our review of a number of cases tended to confirm this observation by IRS staff. Thus, we believe that the penalty provision of the MOU should only be modified based on evidence that supports the need for such action.

At the present time, we do not believe that sufficient information exists to support the need for a penalty tolerance. At the time of our review, IRS was not able to provide any documentation supporting its rationale for establishing the tolerance. Its comments on this matter offer no further insights on the need for this policy.

**Issuing Regulations for
Filing Form W-2s**

IRS agreed with our recommendation to revise its regulations to require the filing of Forms W-2 and W-3 within 30 days after a business terminates operations. It said that a regulation project has been initiated and will be pursued on a priority basis.

Trust Fund Accounting Issue Needs to Be Resolved

The wage certification problem, discussed in our 1987 report and caused by the difference in the amount of wages reported by employers separately to the Social Security Administration and the Internal Revenue Service, remains unresolved. Billions of dollars have been and are continuing to be credited to the social security trust funds that are not supported by wages reported to SSA in accordance with the funding procedure established in the Social Security Act.

With reconciliation efforts complete for a large segment of the work associated with past differences, it is time to address the funding question: "What is the appropriate amount of revenues owed to the social security trust funds each year?" Continuing to ignore the problem, is not in the long-term interests of the government or program management. After weighing options for resolving the funding problem, we conclude that funding of the trust funds should be based on the amount of social security tax revenues collected.

The Trust Funding Problem

Section 201(a) of the Social Security Act requires that social security tax revenues collected by IRS be transferred from general revenues of the Treasury to the social security trust funds and the amounts must be based on the amount of wages SSA certifies as entered on its records. Since 1978, employers have generally reported more wages on their reports to IRS than they reported to SSA (see discussion in chs. 1 and 2). Concerned about the completeness of its wage records, SSA has decided to make interim certifications for trust fund accounting purposes, based in part, on IRS wage records. SSA's justification for this action is that social security taxes on these wages likely have been collected and the revenues should be available to the trust funds.

Except for tax years 1981 and 1988, the initial amount of wages employers reported to SSA has been less than they reported to IRS. Even after reconciliation efforts for tax years 1978-86, SSA has recorded over \$65 billion less on its earnings records than has IRS for the period. The effect is that more than \$9 billion in social security tax revenues provisionally credited to the social security trust funds by the Treasury for this period are not supported by SSA records. Cases for tax years 1987-89 have been referred to IRS for further reconciliation, and additional unsupported tax revenues have been credited to SSA for this period as well.

Timely, Accurate Accounting Needed

From the government's perspective, a timely, accurate accounting of trust fund revenues is important. To meet its obligations, the government borrows social security tax revenues that are in excess of program benefit and operating needs. In return, the trust funds receive interest-bearing government securities guaranteed as to both principal and interest.

Treasury borrowed the additional \$9 billion in the trust funds and paid interest on this amount. To continue this interim process significantly increases the government's long-term obligations to the social security trust funds by overstating the principle of the loan and compounding interest charges on the unsupported principle.

From a program management perspective, an accurate revenue accounting is needed because trust fund balances are used to assess the future financial solvency of the programs. The Social Security Act requires that the fiscal soundness of the social security programs be actuarially examined annually. Any anticipated shortfalls in the funds' future solvency are to be immediately reported to the Congress. Overstated trust fund balances portray overly optimistic solvency projections by misstating assets and associated investment income, undercutting the effectiveness of these examinations.

We Favor a Collection-Based Funding System

At the request of SSA's Commissioner, we evaluated several options on how to resolve this funding issue in 1991. They were to certify wages on the basis of (1) wages recorded annually in the individual earnings records and the suspense file,¹ (2) the quarterly reports submitted to the IRS, and (3) wages recorded annually in the individual employee records and the suspense file plus a portion of the unresolved SSA reconciliation cases. (See app. I.)

In evaluating the options, we believed it important to consider several factors, such as the following:

- The self-financing concept that has governed the programs since their inception, under which dedicated employment-related tax revenues, rather than general revenues, are used to finance social security programs.
- The changes in trust fund accounting approaches that have occurred over the life of the social security programs, showing that there is no overriding

¹The suspense file contains earnings that SSA cannot credit to an individual because it cannot identify a valid social security account.

historical precedent for the current certification process outlined in the act.

- The effects of the change in the wage-reporting process that became effective in tax year 1978, breaking the linkage that previously existed between the collection of tax revenues and the recording of wages for social security purposes.

In our response to the Commissioner, we concluded that the most appropriate solution appeared to be to credit revenues to the trust funds based on the social security tax revenues that the IRS collects each year. We preferred a collection-based system for several reasons.

First, it would be consistent with both overall good management practice and the programs' self-financing concept. Only social security tax revenues collected would be credited to the trust funds. Presently, the trust funds receive credit regardless of whether the taxes owed are collected. Such a funding approach would treat the trust funds and the general revenue fund of the government separately and equitably.

Second, a change in the funding approach would be consistent with the funding history of the program. Changes have been made in the interest of the government and program operations over the years. Establishing a collection-based system would return to the initial program funding concepts.

Finally, it would address the funding effects that arose with the change in the wage-reporting process in 1978. A collection-based system would remove the funding concerns that arise from the differences in wages reported separately to IRS and SSA. While these differences remain important to each agency for internal control purposes, a collection-based funding approach would reduce their significance for trust funding purposes.

Establishing a collection-based system would require accurate tracking of social security tax revenues collected by IRS. But IRS already receives the information it needs from employers to determine the amount of social security taxes it collects. Our preliminary discussions with IRS officials did not identify any specific problems with a collection-based funding approach.

Like the collection system used before 1950, the trust funds would receive any interest and penalty revenue collected because of the late payment of

social security taxes. If feasible, the Treasury might offset such revenue to recover its collection costs so that the general revenue fund would be equitably treated. Revenues transferred to the trust fund would be based on the Secretary of the Treasury certifying the amount of social security taxes collected.

Changing the funding system would not affect SSA wage-processing and benefit computation systems. The wage-reporting process would not be affected nor would the internal control benefits that accrue to the government from the current process.

Conclusion

The funding problem caused by the inability to fully reconcile SSA and IRS wage records needs to be resolved. But following the approach established in the Social Security Act would result in the return of collected and dedicated social security tax revenues to the Treasury, an outcome that is inconsistent with the purpose for which the taxes were collected. Instead, we favor an amendment to the act to establish a collection-based funding approach. Such an approach would address the cause of the trust fund problem, return to a funding approach that is consistent with the history of the program, and update the accounting system to reflect the effects of changes in the wage-reporting process on trust funding.

Matter for the Consideration of the Congress

The Congress should consider amending section 201(a) of the Social Security Act to require that revenues credited to the social security trust funds are based on the amount of social security taxes collected each year, including interest and penalties. The Secretary of the Treasury should certify to the amount of social security taxes collected.

Agency Comments and Our Evaluation

SSA commented that our recommendation to provide revenues to the trust funds based on the amount of social security taxes collected may be premature. SSA believes that it would be more appropriate to consider the funding issue in the context of work being done between SSA and IRS to redesign the wage-reporting and employment tax collection system. SSA said this effort may result in a funding approach that is entirely different than the solution we have proposed.

In this chapter, we have proposed that the Congress consider establishing a collection-based approach as the means for determining the amount of revenues owned to the social security trust funds. Such a funding system

would not be affected by the manner in which wages are reported to the government.

SSA written comments reflect ongoing discussions between itself, IRS, and others about possible changes in the current wage-reporting and employment tax collection approach. SSA's comments, however, gave no details about how this new system might work, how program funding might change, or when changes might be made.

We contacted SSA to obtain further information about how its deliberations related to these issues. We were told that while the project is being actively pursued by SSA and IRS, many decisions on its scope and operations have not yet been made. For example, should the changes involve only wage reporting to SSA and IRS, or be more comprehensive, bringing in wage reporting to the states for unemployment program purposes.

We also were advised that SSA's current efforts do not address how any changes in reporting might affect trust funding—that is, either the amounts in dispute from the unreconciled backlogged cases or how future trust fund revenues might be determined. Finally, the most optimistic estimates of when changes could be implemented are near the end of the decade.

Given the indefiniteness of these efforts and the estimated time they will take, we disagree with SSA that it would be premature to address the funding problem now. The problem has existed for 14 years, affecting billions of dollars in trust fund assets and hundreds of millions of dollars in annual interest income. Thus, we continue to believe that the Congress should act now to address the problem, with the view that possible refinements could be warranted in future years.

GAO Letter to the Commissioner of Social Security on Trust Funding Options

GAO

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

Human Resources Division

March 25, 1991

The Honorable Gwendolyn S. King
Commissioner of Social Security

Dear Mrs. King:

In your June 22, 1990, letter, you asked for our views on the certification requirements set forth in section 201(a) of the Social Security Act. Certification refers to the process that establishes the amount of tax revenues that the social security trust funds are entitled to receive to meet operating and benefit payment obligations of the title II social security programs (Retirement, Survivors, and Disability Insurance).

Section 201(a) requires that the amount of revenues appropriated to the trust funds be determined by the Secretary of the Treasury. This is done by applying the social security tax rates to the amount of wages that the Secretary of Health and Human Services (HHS) certifies as entered on the Social Security Administration's (SSA) records. Because revenues are initially provided to the trust funds on an estimated basis, any amounts that the Secretary of HHS cannot certify must be returned to general revenues.¹

For more than a decade, SSA has been concerned about the completeness of its records. Specifically, since 1978 about 500,000 employers each year have reported paying higher amounts of wages to the Internal Revenue Service (IRS), which collects social security tax revenues, than to SSA, which records individual worker earnings. This difference in reported wages is important because benefits under the title II social security programs are based on a person's lifetime earnings. Consequently, errors in SSA's earnings records could lead to benefit payment errors.

We reported on this problem in 1987. Since then SSA has worked with IRS and employers to reconcile differences in wage reports.² Despite these efforts, about \$68 billion in wage-report differences still exist for tax years 1978-86. Certifying based on SSA's records means that the trust funds would lose over \$9 billion in revenues to the general revenue fund of Treasury.

¹In practice, SSA certifies earnings on behalf of the Secretary of HHS.

²See Social Security: More Must Be Done to Credit Earnings to Individuals' Accounts (GAO/HRD-87-52, Sept. 18, 1987).

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You expressed concern that social security taxes have been paid on some of these unreconciled wage differences. You also questioned the appropriateness of returning tax money collected specifically for social purposes to the general revenue fund.

Your letter outlined three broad certification options for our consideration, two of which would require a change in legislation. All three options have certain advantages. But we believe that in each option the advantages are outweighed by disadvantages. Therefore, we favor a collection-based funding approach, primarily because it would result in a far higher degree of certainty about the amount of revenues that should be credited to the trust funds to meet program obligations. Under such an approach the trust funds would receive the social security tax revenues actually collected, including interest and penalties. Such a system is similar to your option 2, but, in our view, is a more equitable way of addressing the funding problem (see attachment II).

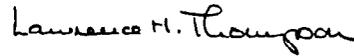
Attachment I describes more fully the nature of the certification problem and factors that we considered in addressing your concerns. Attachment II discusses our views about the pros and cons of each approach outlined in your letter. It also describes the reasons that we favor an approach that would fund the social security programs based on the amount of social security tax revenues that the government collects each year.

Although we favor a certification approach based on the social security taxes collected, we want to emphasize that we believe the present comparison of wages reported to SSA on form W-2 and to IRS on form 941, as well as the reconciliation of any differences identified, should be continued. This comparison acts as an effective internal control by identifying potential wage-reporting problems. For example, over 500,000 employers who had previously not filed wage reports with SSA sent W-2s in response to reconciliation inquiries. While there are limitations in SSA's data on reconciliation results, it is likely that many of these earnings were newly credited to worker accounts.

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We appreciate the opportunity to assist in your deliberations on this complicated policy issue. In addition, because of the pertinence of this issue, we are sending copies of this letter to the Senate Committee on Finance and the House Committee on Ways and Means. If you should have any further questions on this matter please call me on (202) 275-5470.

Sincerely yours,



Lawrence H. Thompson
Assistant Comptroller General

Attachments - 2

Attachment I

History of the Wage Certification Problem

Accurate earnings information is important to the Social Security Administration because the lifetime earnings of each worker are used to establish their eligibility for and the amount of social security benefits they will receive. In 1987, we reported that significant differences existed in the amount of employee social security wages reported to the Internal Revenue Service versus those reported to SSA for tax years 1978-84. Each year, about 500,000 employers reported more wages to IRS than to SSA, indicating that SSA was missing \$58.5 billion in wage reports.

The problem also affected the amount of money available to pay program benefits and administrative costs. Section 201(a) of the Social Security Act requires that social security tax revenues be transferred from general revenues to the trust funds on the basis of wages certified as entered on SSA's records. Such a provision is needed because IRS does not determine the amount of social security tax revenues it collects.

Because SSA was concerned about the completeness of its earnings records, it has not followed the certification requirement in law. Instead, it has made "interim" (provisional) certifications for trust fund accounting purposes since 1978. The interim certifications are based on IRS records that reflect aggregate social security tax liabilities acknowledged by employers on quarterly information returns.

Since 1978, IRS records have consistently shown a greater amount of social security wages than SSA has recorded on its books. As a result, SSA records have not supported the amounts credited to the social security trust funds by the Department of the Treasury, in accordance with the procedure established by law. At the time of our 1987 report, about \$7.7 billion had been credited to the trust funds for tax years 1978-84 that was not supported by SSA wage records.

To address both historical and future wage-reporting differences, SSA decided to contact employers filing the questionable wage reports. Over the past 3 years, it has primarily worked on tax year 1978-86 cases. Under its program, SSA sought from employers explanations for the differences in the reports they had sent to IRS and SSA and requested correcting wage reports. SSA's reconciliation efforts, however, have not been fully successful.

Sometimes SSA obtained wage reports in response to its inquiries. For example, SSA received over 11 million W-2s for tax years 1978-84 from its reconciliation efforts. At the same time, the discrepancy between its

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wage records and IRS's has been reduced to \$36 billion from the \$58.5 billion we identified in our 1987 report.

SSA also obtained information from employers showing that its records were correct. For example, some employers had filed wage reports with SSA under one employer identification number and with IRS under another number. The use of different employer identification numbers made it appear as though SSA was missing wage reports from a particular employer. After learning about this reporting discrepancy, SSA found it had already recorded the wage data that appeared to be missing.

However, in many other cases SSA was not successful in either obtaining new wage reports or identifying the reason for the difference. Many employers could not be located because they had gone out of business. Others lacked the records needed to respond to SSA. As a result, there are still significant amounts of unreconciled wages and the prospects for resolving these cases are not good.

The treatment of these unreconciled wages for trust fund accounting purposes underlies SSA's concern. Following the procedures in section 201(a) would require SSA to return over \$9 billion credited to the trust funds for tax years 1978-86. This would occur even though it appears that social security taxes were due and paid on at least some of these amounts.

This concern has prompted you to question whether the certification requirement should be changed. You outlined three certification options in your letter and asked for our views on them. The options and our views about them are presented in attachment II. In forming our views, we considered several factors related to the social security programs and their relationship to the collection of social security taxes and trust fund accounting. These include

- the basic self-financing principle that has governed the programs since their inception,
- the changes in approaches for determining the amount of revenues available to the trust funds since program inception and the underlying rationale for establishing the section 201(a) certification requirement, and
- the effects of changes in the wage-reporting process that became effective in tax year 1978.

**Attachment I
History of the Wage Certification Problem**

**Social Security
Programs Are
Self-Financing**

The title II social security programs (Retirement, Survivors, and Disability Insurance) were established by law to be self-financing. Program benefits are paid from trust funds that principally receive money generated by dedicated employment taxes on designated amounts and types of wages and self-employment income. The programs were not designed to be financed through general revenues derived from income or other general-purpose taxes.

The self-financing principle is fundamental to the insurance concept of the Retirement, Survivors, and Disability Insurance programs. It has governed their operation since their establishment in 1935, 1939, and 1956, respectively. Although the self-financing concept has been a consistent feature of the programs, the Congress has made changes to the method for determining the amount of social security tax revenues due the trust funds over the years.

**Methods for
Determining Trust
Fund Revenues Have
Changed**

Three approaches have been used to fund the social security programs. The authorizing legislation in 1935 established an Old Age Reserve Account to build up a reserve sufficient to pay benefits under the program. Under law, the account was to receive an annual appropriation, beginning in fiscal year 1937, sufficient to pay benefits and build up a required reserve.

Beginning in 1937 the original act also established payroll taxes on employees and employers based on a percentage of each worker's annual wages. The original act, however, did not link the appropriations made to the Old Age Reserve Account with the taxes collected because of constitutional concerns about such an approach. However, minority views on the legislation indicate that there is no doubt that the taxes were imposed to raise revenues for the insurance programs.

The ambiguity of this original funding approach did not last long, however. The Social Security Amendments of 1939 created a social security trust fund that received revenues on a collection basis. That is, the law simply required the Department of the Treasury to transfer to the trust funds all of the social security tax revenue (including interest, penalties, and additions to the taxes) that it collected. This collection-based funding approach stayed in place for over a decade.

In 1950, the Congress changed the funding approach again. Section 201(a) of the Social Security Act simplified the tax collection procedures for both the taxpayer and the government. Under this section, the trust

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funds receive revenues based on the total amount of social security covered wages certified as being recorded for each individual in SSA's records. Treasury then applies the appropriate tax rate to the certified aggregate amount of social security wages recorded by SSA and transfers revenues to the trust funds.

Under this funding approach, the trust funds do not receive any interest and penalty revenue derived from the late payment of social security taxes. In theory, there are no late payments under this funding approach. Section 201(a) provides that the trust funds receive tax revenue for all social security wages regardless of whether Treasury collects the taxes.

In reality, the funding process for the programs is more complex. At the beginning of each month Treasury advances tax revenues to the social security trust funds based on estimates of social security taxes to be collected during the month. The advance is immediately invested in short-term securities and the general fund pays social security benefits for the month.

The trust funds reimburse the general fund by redeeming the Treasury securities they hold. The certification process is supposed to periodically adjust these estimates when SSA advises Treasury of the total social security wages SSA has recorded.¹ If the estimates are too high, funds are to be returned to the general revenues of Treasury. If they are too low, additional funds are to be credited to the social security trust funds.

**The Relationship
Between Wage
Reporting and
Certification**

In considering the funding of the social security programs, it is important to recognize that when section 201(a) was enacted a strong linkage existed between the wage reports SSA received to record worker wages and the wage reports Treasury received to assure the proper collection of taxes. Specifically, this linkage centered on employers filing form 941 and attachment A with IRS.

Form 941, an employer tax-information return, shows aggregate information on the amount of (1) total wages and (2) taxable social security wages the employer paid to its employees during the previous business quarter. The form also shows when the employers' paydays occurred and the employers' aggregate tax liability (for both income and social security taxes) for each payday in the quarter. This latter information

¹Section 201(a) does not mandate the frequency of certification

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History of the Wage Certification Problem

indicates to employers when they must deposit withheld employee taxes and their share of the social security tax with Treasury. IRS uses this information to determine whether employers have deposited taxes in a timely manner and in accordance with their acknowledged liabilities.

Attachment A supported the aggregate amounts reported on form 941 by showing the wages and taxes withheld from each employee during the quarter. IRS would provide SSA with all attachments A and SSA used them to record each worker's earnings during the quarter. Thus, under this system the same employer wage report was used for social security and tax collection purposes and it was highly probable that SSA's wage records would equal IRS's tax records.

In 1978, the close linkage between IRS's tax collection and SSA's wage-recording process was broken by an important change in the wage-reporting process. To decrease employer wage-reporting burdens, the Congress established a combined annual wage-reporting process. Under combined annual wage-reporting, employers no longer had to prepare and file the detailed attachment A with the quarterly form 941 reports.

To provide SSA with the wage information it needed to record each worker's wages, the Congress required that employers send SSA the annual form W-2 wage report for each of their workers. The change in the wage-reporting process did not affect the certification requirements in section 201(a). Thus, under the combined annual wage-reporting process, SSA must now certify wages based on form W-2 reports while IRS still monitors employer tax deposits using form 941.

The change assumed that the sum of the employee wages reported to SSA by each employer on form W-2 would equal the aggregate amounts reported to IRS for the 4 calendar quarters on form 941. Yet situations do occur during the year that can lead to reporting and administrative errors and, ultimately, imbalances between SSA and IRS records.

For example, business closings and mergers can underlie the differences in the two agencies' records. When an employer goes out of business in the middle of the tax year, it may have filed quarterly forms 941 with IRS. The employer, however, would not be in business when it comes time to file forms W-2 with SSA after the end of the tax year. In such cases, SSA could be missing the wage reports it needs for social security purposes.

**Appendix I
GAO Letter to the Commissioner of Social
Security on Trust Funding Options**

**Attachment I
History of the Wage Certification Problem**

In cases where businesses merge, other problems can occur. For example, a new employer identification number could be issued for the new business created by the merger. This can lead to situations where IRS has some forms 941 filed under the employer identification numbers of the original businesses but SSA has not received any forms W-2 under those identification numbers. Rather, it has received wages reported under the new employer identification number.

Contacting these employers and attempting to reconcile the reported differences represented a substantial work load; and for some time IRS and SSA differed over who was responsible for reconciling these differences. The dispute was resolved when SSA agreed to (1) reconcile these reporting differences for older cases—tax years 1978-86—and (2) make the initial reconciliation attempts for subsequent tax years. IRS agreed to assist SSA in reconciling certain backlogged cases and for all cases after tax year 1986 where employers do not respond to SSA's inquiries. In addition, both agencies have worked toward making refinements in the reporting process to reduce administrative causes for the differences.

Attachment II

SSA Options and Our Analysis

Your letter broadly outlines three options to address the certification problem arising from reconciliation of wage reports. The options, the pros and cons of each, and our overall views about the certification question follow.

Option 1: The Current Process Required by Law

This option follows the certifying procedure specified in section 201(a). Under this approach SSA would certify on the basis of wages recorded annually in its individual earnings records and its suspense file. Option 1 would result in about \$9 billion of tax year 1978-86 revenues that have been credited to the social security trust funds on the basis of IRS wage reports being returned to general revenues.

The biggest advantage of option 1 is that it is the easiest approach to take. No changes in law are required to implement this approach. In addition, the option results in the trust funds receiving only the tax revenues clearly supported by SSA records. Thus, to the extent that unreconciled wage amounts represent administrative recording problems rather than missing or wrongly reported amounts, the general fund will not bear the burden of meeting social security obligations.

Option 1 has disadvantages, however. First, it results in a substantial loss of revenues currently available to the trust funds.

Second, this option allows the funding problem caused by the 1978 change in the wage-reporting process to continue. Over the past 10 years, IRS's records have consistently shown greater amounts of social security wages than SSA's records. In effect, option 1 does not address the certification problem; rather, it ignores it.

Finally, although option 1 credits only social security tax revenues to the trust funds and returns to general revenue all provisionally credited taxes associated with all unreconciled amounts, it is also likely to return some paid social security taxes as well. Thus, under this option social security tax revenues would become available for general spending purposes rather than the dedicated purposes for which they were collected.

Option 2: The Interim Process Used Provisionally Since 1978

Under option 2 SSA would certify taxable social security earnings based on quarterly reports submitted to IRS by employers in connection with the payment of withheld income and social security taxes. Option 2 is the procedure that SSA has followed on an interim basis since 1978, when the combined annual wage-reporting process began. Under this approach SSA would not need individual wage records to support the revenues provided to the trust funds as the law presently requires.

The social security trust funds would retain all of the revenues provisionally credited to the trust funds based on IRS tax records under option 2. Given the complexity and technical nature of this issue, this approach would likely cause little controversy because no significant change in the trust fund balance would occur. In addition, this approach has the advantage of addressing the certification problem that arose from the combined annual wage-reporting process.

Like the previous option, however, this approach has disadvantages. One is that the trust funds will likely retain some revenues that are not social security tax revenues. Sometimes the differences between SSA and IRS records do not represent missing wage reports. Rather, they represent administrative reporting problems. Thus, contrary to the self-financing principle of the program, option 2 would result in the trust funds receiving some general revenue funds to meet their obligations.

Second, under this approach uncertainty would continue to exist as to the correct amount of revenues due the trust funds. It is likely that different amounts would continue to be reported to IRS and SSA because the wage-reporting process is not altered under this option. Thus, while option 2 addresses the certification problem, it tends to favor the social security trust funds over the general fund.

Third, as outlined in your letter, option 2 implies that SSA will certify wages using IRS-processed taxpayer data. SSA cannot meaningfully attest to the correctness of records that are prepared by another federal agency. Only Treasury can certify the amount of social security taxes related to its records.

Option 3: The Compromise Approach

Under option 3 SSA would certify based on wages recorded in its individual records and its suspense file, plus a portion of the wages that remain unreconciled. This portion would estimate the amount of revenues that would be credited to the trust funds if the employers or records could be found.

**Appendix I
GAO Letter to the Commissioner of Social
Security on Trust Funding Options**

**Attachment II
SSA Options and Our Analysis**

In your letter, you did not describe how the estimate would be made. One way to make such an estimate would be to assume that taxes from unreconciled wage reports should be credited to the trust funds in the same proportion as for those where additional data have been obtained and posted. In this way the trust funds should be credited for taxes on missing or wrongly reported wage amounts but not for duplicate reports or other administrative reporting errors.

Option 3 is a compromise approach. Its biggest advantage is that, like option 2, it recognizes that differences exist and attempts to address them. This option recognizes that a portion of the unreconciled wage amounts resulted in social security taxes actually paid by employers and employees and provides that the trust funds will get the money for their estimated value.

Option 3 would be an acceptable alternative if a reliable estimate of the amount of new wages recorded from reconciliation could be made. However, based on our understanding of available SSA data, we do not think that it is possible to make a reliable estimate because of the way SSA tracks reconciliation results. Specifically, SSA does not track its reconciliation results to determine the amount of new wage data that was recorded. Rather, it set up its tracking program to assure itself that all employers who filed questionable wage reports were contacted and asked to correct the problem. SSA has only broadly tracked the results of its contacts with employers.

Without this information, we do not think the compromise approach is the best way to address the certification problem. It would simply recognize that a yearly problem exists and make an estimate that may not be equitable to either the general revenue fund of the government or the social security trust funds.

**GAO Favors a
Collection-Based
Funding Approach**

We believe all three options as outlined in your letter have disadvantages that exceed their advantages. As a result, we favor a collection-based funding approach. Although similar to option 2, a collection-based system, in our view, is a more equitable solution.

Under such a system, the trust funds would receive only the social security tax revenues collected by Treasury through the federal tax system. As under the collection system used before 1950, the trust funds would receive any interest and penalty revenue collected because of the late payment of social security taxes. If feasible to account for, Treasury

**Appendix I
GAO Letter to the Commissioner of Social
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**Attachment II
SSA Options and Our Analysis**

could offset such revenue to recover its collection costs so that the general revenue fund is equitably treated. Revenues would be transferred to the trust funds based on the Secretary of the Treasury certifying the amount of social security taxes collected.

General revenues would not make up any short fall in social security tax revenue collections and the general fund would not receive any revenues specifically intended for social security. A collection system existed before, and we believe such an approach best fits the self-financing concept of the program because program obligations are paid only with social security tax revenues.

In addition, a collection-based approach addresses the certification problem that arose with enactment of the combined annual wage-reporting process in 1978. Using such an approach removes the funding concerns that arise from the differences in wage amounts reported separately to IRS and SSA. While these differences remain important to each agency for internal control purposes, a collection-based funding approach removes their significance for funding reasons.

This approach would require a legislative change to the Social Security Act, as would options 2 and 3, as outlined in your letter. Moreover, the approach would require more accurate tracking of social security tax revenues collected by Treasury. Treasury, however, already receives the information it needs from employers to determine the amount of social security taxes it collects, and our preliminary discussions with Treasury officials did not identify any specific problems with a collection-based funding approach.

Comments From the Social Security Administration



DEPARTMENT OF HEALTH & HUMAN SERVICES

Social Security Administration

Refer to: S6A-1

Baltimore MD 21235

July 15, 1992

Mr. Joseph F. Delfico
Director
Income Security Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Delfico:

Enclosed is the response of the Social Security Administration on the General Accounting Office Report "Social Security: Reconciliation Improved SSA Earnings Records, But Efforts Were Incomplete."

Thank you for the opportunity to comment on the report.

Sincerely,

A handwritten signature in cursive script that reads "John R. Dyer".

John R. Dyer
Deputy Commissioner
for Finance, Assessment and Management

Enclosure

**Appendix II
Comments From the Social Security
Administration**

COMMENTS OF THE SOCIAL SECURITY ADMINISTRATION ON THE GENERAL
ACCOUNTING OFFICE DRAFT REPORT, "SOCIAL SECURITY: RECONCILIATION
IMPROVED SSA EARNINGS RECORDS, BUT EFFORTS WERE INCOMPLETE"
(GAO/HRD 92-81)

General Comments

We appreciate the General Accounting Office (GAO) effort in reviewing the progress made by the Social Security Administration (SSA) and the Internal Revenue Service (IRS) to resolve differences in the wages reported to both agencies by employers. We are pleased with GAO's recognition of the substantive accomplishments that SSA has achieved since 1987. We are also encouraged by GAO's recognition of IRS' responsibility in the reconciliation process.

Overall, we view the report as quite favorable. However, because of the shared responsibility in the reconciliation process, we believe that IRS should be mentioned in the title. As it is now, the title may establish a misleading impression about the responsibility for the reconciliation process.

The report recommends that Congress consider amending Section 201(a) of the Social Security Act to provide that the trust funds receive revenue based on the amount of Social Security taxes collected each year. This recommendation may be premature. We consider it more appropriate to allow this issue to be considered in the context of work being done between SSA and IRS to look at alternative possibilities as to how the Nation's wage tax reporting system should be redesigned. That effort may result in an approach that may yet be entirely different than what is being proposed by GAO.

GAO Recommendation

SSA and IRS should amend the Memorandum of Understanding (MOU) to assure that reasonable efforts are made to contact employers whenever SSA does not have its reconciliation letters delivered.

SSA Comment

We agree. We are currently negotiating with IRS to change the MOU to indicate that IRS will review its address files to determine if a different address exists for a particular employer.

GAO Recommendation

SSA should place more emphasis on identifying and addressing causes of employer problems in reporting wages. It should examine the clarity of its wage reporting instructions and consider how it can better respond to employer wage reporting questions, such as providing a single contact point for employers.

SSA Comment

We agree. In fact, SSA has already undertaken a variety of initiatives to identify and address the causes of employer reporting problems in reporting wages. Some of the actions taken include:

Reconciliation Resolution Task Force

- o This task force was formed in 1987 to study the causes for reconciliation cases and to suggest corrective actions. As a result of the task force recommendations, improvements were made to the instructions on the tax forms and W-3 to clarify to the employers that the Employer Identification Numbers (EINs) and money amounts are compared and that they must match; the Form W-3 was modified to include cross-reference EINs; and SSA began educational efforts that focused on certain types of employers.

Publications and Instructions

- o Effective with tax year (TY) 1990, SSA developed and issued new Software Standards and Edit Criteria for Annual Wage Reporting (AWR), Publication 31-011, which provides programmers with standards for software producing wage reports, data specifications for report entries and edits to check the accuracy of those entries. The TY 1991 version of Publication 31-011 included a new addendum which provided reporting examples illustrating (1) proper application of the guidance in Publication 31-011, (2) the most common types of errors SSA is trying to prevent and (3) the interrelationship between Forms W-2 and W-3 (sent to SSA) and Form 941 (sent to IRS).
- o SSA made special mailings of Publication 31-011 to (1) State Certified Public Accountant Associations and (2) major software development firms specializing in payroll and wage reporting, explaining why it was important to comply with the publication's requirements.

- o SSA placed Publication 31-011 and its Magnetic Media Reporting Guidelines onto the IRS electronic bulletin board service (IRS-BBS) for public access. This service provides the public with the latest available wage reporting guidelines in the fastest manner possible through electronic access. Using this service, the public can also electronically ask SSA questions about AWR and SSA can respond electronically.
- o In conjunction with using the IRS-BBS, SSA is developing its own electronic bulletin board service to expand the public's electronic access to wage reporting guidance. Like the IRS-BBS, this service will also permit SSA to electronically respond to public questions on AWR.
- o SSA revised its long-standing publication, Reporting Improvement Program for Employers (RIPE). The RIPE package is used by SSA in conducting small business seminars and workshops on AWR, and the revised package is more user friendly for field office staffs and can be used by employers as a self-help resource.

Education and Public Awareness Campaigns

- o On a national level, SSA has educated the public on AWR and reconciliation through a variety of conferences sponsored by payroll trade associations, software developers and other employer organizations.
- o SSA is currently conducting a pilot in the State of Maryland to reach employers who have been experiencing wage reporting problems. The purpose of the pilot is to educate the employers in proper wage reporting. Depending on the results of the study, the outreach may be expanded nationwide.
- o Over the past 2 years, SSA has sponsored its annual Employer Payroll Reporting Conference. This joint Federal/private sector forum is designed to (1) educate the public on AWR and reconciliation, (2) provide the status of initiatives the Government is undertaking to improve the AWR process and (3) address AWR issues raised by the private sector.
- o SSA and IRS established an AWR policy board to address areas such as single wage reporting, uniformity of forms, common definition of wages and ongoing policy review.
- o SSA developed a specific AWR presentation package for use by regional representatives in educating the public through seminars and workshops. The package addresses topics which include an overview of the AWR process (including reconciliation) and the most common reporting problems.

- o SSA's Office of Public Affairs (OPA) developed promotional pamphlets, for both employers and employees, on why accurate wage reporting is essential from the perspectives of each. These pamphlets are used in conferences, seminars and workshops on AWR.
- o To complement the promotional pamphlets, SSA also developed an AWR table-top exhibit for use at conferences. This exhibit is specifically designed to market AWR.
- o SSA is promoting direct participation in AWR public awareness campaigns by involving labor unions that represent industries and professional groups where wage reporting problems have been identified. For example, to improve the reporting accuracy of name/Social Security number (SSN) combinations, SSA is working with the United Farm Workers Union to develop a promotional campaign for its membership which will include explaining the Social Security programs and the importance of providing correct names and SSNs to employers.
- o SSA has incorporated into its strategic plan an initiative to establish a "help desk" served by a single purpose telephone number. It will be available specifically to provide assistance to the business community for payroll issues and annual wage reporting requirements. The new telephone system would improve SSA's service by more effectively providing timely and accurate wage reporting information. Plans are to have this single purpose telephone number available to the business community beginning fiscal year 1995.

System Development Efforts

- o SSA is modernizing its reconciliation system. The new system, scheduled for implementation in October 1993, will be a transaction-based system using updated wage data from both IRS and SSA files to continually identify wage discrepancies, revise case status, initiate employer contact or close reconciliation cases.
- o Using its earnings records, SSA developed the Personal Earnings and Benefit Estimate Statement (PEBES). PEBES is an informational tool the public can request from SSA.

Using PEBES, the public can check the accuracy of their annual earnings and contact SSA to correct any discrepancies (in addition to receiving eligibility and benefit estimate information).

**Appendix II
Comments From the Social Security
Administration**

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- o The public's ability to check its earnings against SSA wage records will improve in future years through unsolicited PEBES statement mailings. Effective September 30, 1995, SSA will send unsolicited PEBES statements to individuals who attain age 60. Effective October 1, 1999, SSA will send unsolicited PEBES statements to each eligible individual on an annual basis.
- o SSA is conducting a pilot study to assess employer interest/use of its Enumeration Verification system (EVS), and to measure its effectiveness in reducing accretions to the Suspense File if the service were promoted and expanded nationally. EVS is a service provided to employers, at their request, in which SSA will accept their payroll records of individual names/SSNs and match them to the SSA NUMIDENT data base to identify which names/SSNs appear to be invalid. Employers then have an opportunity to correct their employment records and the Form W2s before they file their annual wage report. For the pilot, a sample of approximately 3,200 employers is being invited to use the EVS service.

Other Comments

The draft report infers that there continues to be reconciliation cases which SSA could prevent. In many instances these cases are the result of the different reporting dates for the Form 941 (January 31) and the W-2/W-3s (February 28). Employers often fail to assure that the total of the two forms are the same, thus causing reconciliation cases.

The report indicates that SSA has many organizational components that play a role in the wage reporting process, but that it does not have a focal point to coordinate all the various efforts. We will consider the appropriateness of developing a formal organizational structure to perform this function.

Finally, we note that the report cites the Office of Policy as helping to prepare wage reporting instructions (p. 33). This reference should be to the Office of Programs.

Now on p. 23.

Comments From the Internal Revenue Service



COMMISSIONER

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

JUL 16 1992

Mr. Joseph F. Delfico
Director, Income Security Issues
Human Resources Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Delfico:

Thank you for the opportunity to review your recent draft report entitled, "Social Security: Reconciliation Improved SSA Earnings Records, But Efforts Were Incomplete".

We are in general agreement with the report and acknowledge the problems noted in completing the 1987 reconciliation cases. All of the issues raised in the report are items that have been discussed with GAO and SSA in previous meetings. The report's recommendations involve IRS compliance with provisions in the SSA/IRS Memorandum of Understanding (MOU) and lists specific IRS actions to improve the wage reporting reconciliation process. Our comments on these recommended actions are as follows.

Eliminate penalty tolerances. While the MOU does not specifically address tolerances for this program, the tolerances currently used are quite low. However, we are willing to negotiate tolerance amounts with SSA.

Issue regulations to mandate the filing of Forms W-2 within 30 days after a business terminates operations. We fully agree with this recommendation and have initiated a regulations project. Efforts are being made to actively pursue this project on a priority basis.

IRS should contact all employers in cases referred by SSA (including "Undeliverables"). Beginning with tax year 1991, the IRS has agreed to work those undeliverable cases in which the address that the IRS has is different from that used by SSA. While SSA has access to address information from the IRS Business Master File (BMF) and is using our most current addresses, there are instances in which the IRS has received an address update since the information was provided to SSA. However, we do not see any advantage to the IRS working cases in which the address is unchanged. We will work with SSA to incorporate appropriate language on this issue into the MOU.

**Appendix III
Comments From the Internal Revenue
Service**

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Mr. Delfico

The report also recommends that SSA should place more emphasis on identifying and addressing causes of employer problems in reporting wages. The recommendation further states that SSA should examine the clarity of its wage reporting instructions and consider how it can better respond to employer wage reporting questions, such as providing a single contact point for employers. In this respect, the IRS has revised the 1992 Form W-3 instructions to clarify how employers should reconcile the adjusted total of social security wages and tips on the Form W-3 with the amounts reported on Forms 941, 942, and 943. We also added a note about the importance of reconciliation at the beginning of the 1992 Form W-3 instructions. In addition, Circular E (Employer's Tax Guide) and the Form W-2 instructions contain a more detailed discussion on reducing discrepancies between the amounts reported to the IRS and SSA.

The IRS will work with SSA to determine if we can further clarify the guidance in the instructions for the 1993 forms. At a minimum, we will add a reference to Circular E in the Forms W-3 and 941 instructions. If space permits, we will incorporate a more detailed discussion in these instructions.

We hope you find these comments useful.

Best regards.

Sincerely,



Shirley D. Peterson

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