

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Backup Withholding Noncompliance and Underreported Employment Taxes Continue to Contribute Billions of Dollars to the Tax Gap

May 17, 2021

Report Number: 2021-40-030

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

HIGHLIGHTS: Backup Withholding Noncompliance and Underreported Employment Taxes Continue to Contribute Billions of Dollars to the Tax Gap

Final Audit Report issued on May 17, 2021

Report Number 2021-40-030

Why TIGTA Did This Audit

Prior TIGTA reviews identified that, due to a lack of adequate processes, billions of dollars in underreported tax by employers were not addressed and taxpayers avoided payment of billions of dollars in backup withholding. The overall objective of this review was to assess the IRS's progress in making improvements to its Federal tax withholding processes and procedures. In response to recommendations included in the prior reviews, the IRS enacted several corrective actions. However, our analysis of information return filings identified continued significant backup withholding noncompliance and employer underreporting of employment tax, and discrepancy cases remain unworked.

Impact on Taxpayers

The continued noncompliance with backup withholding requirements and underreported taxes by employers and the IRS's lack of adequate actions to address this noncompliance contribute to the Tax Gap. The IRS's most recent estimate of the Tax Gap was \$441 billion (published in September 2019), which the IRS reports is the amount of true tax liability that is not paid voluntarily and timely.

What TIGTA Found

Backup withholding noncompliance continues to result in payers avoiding payment of billions of dollars in withholding each year. For Tax Year 2018, TIGTA identified 182,075 payers that submitted 440,404 information returns for which the payee Taxpayer Identification Number was either missing or incorrect, yet the payers did not backup withhold \$13.3 billion on \$55.6 billion in reported income.

In addition, payers continue to report billions of dollars in payments associated with Taxpayer Identification Numbers of deceased individuals. Our review identified 52,500 payers that submitted 2.7 million information returns for which the payee was deceased at least three years prior to the issuance of the information return. These 2.7 million information returns had reportable payments totaling \$3.7 billion. Generally, payers should not submit information returns using the Taxpayer Identification Number of a deceased taxpayer for identification of the payee. These deceased taxpayer Social Security Numbers are likely being used because payers have not been notified about the death of a payee, an estate Employer Identification Number has not been provided to the payer, [REDACTED]

Finally, due to a programming error, the IRS did not select Combined Annual Wage Reporting discrepancy cases with the highest assessment potential. Our analysis of Tax Year 2017 IRS discrepancy cases determined that the IRS worked 21,372 cases and assessed \$58.8 million. However, for the 21,372 cases worked, TIGTA identified that the IRS still did not select cases with the highest potential tax assessment. Had the programming been working as intended, the IRS could have selected and worked cases with a higher potential assessment, resulting in an additional \$133.1 million in assessments.

What TIGTA Recommended

TIGTA recommended that the IRS develop processes and procedures to identify and address the reporting of income on information returns using a deceased payee Taxpayer Identification Number and conduct an analysis of additional worked discrepancy cases to evaluate the use of the repeater indicator as another characteristic to prioritize Combined Annual Wage Reporting discrepancy cases.

IRS management agreed to develop necessary processes and procedures to identify and address the reporting of income on information returns using a deceased payee Social Security Number. However, management did not agree with the recommendation to conduct an analysis on the use of the repeater indicator on discrepancy cases. Management does not believe there is any evidence that such a study is worth the diversion of its limited resources.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 17, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Backup Withholding Noncompliance and Underreported Employment Taxes Continue to Contribute Billions of Dollars to the Tax Gap (Audit # 201940028)

This report presents the results of our review to assess the Internal Revenue Service's progress in making improvements to its Federal tax withholding processes and procedures. This review was part of our Fiscal Year 2020 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).

Table of Contents

<u>Background</u>	Page 1
<u>Results of Review</u>	Page 2
<u>Backup Withholding Noncompliance Continues to Result in Payers Avoiding Payment of Billions of Dollars in Withholding Each Year</u>	Page 3
<u>Payers Continue to Report Billions of Dollars in Payments Associated With Taxpayer Identification Numbers of Deceased Individuals</u>	Page 8
<u>Recommendation 1:</u>	Page 10
<u>Due to a Programming Error, Combined Annual Wage Reporting Discrepancy Cases With the Highest Assessment Potential Are Not Selected</u>	Page 11
<u>Recommendation 2:</u>	Page 12
<u>Improvements Have Been Made That Provide Flexibility When Working Wage Discrepancy Cases</u>	Page 14
<u>Appendices</u>	
<u>Appendix I – Detailed Objective, Scope, and Methodology</u>	Page 16
<u>Appendix II – Outcome Measures</u>	Page 18
<u>Appendix III – Information Returns Requiring Backup Withholding</u>	Page.24
<u>Appendix IV – Management’s Response to the Draft Report</u>	Page.25
<u>Appendix V – Abbreviations</u>	Page.32

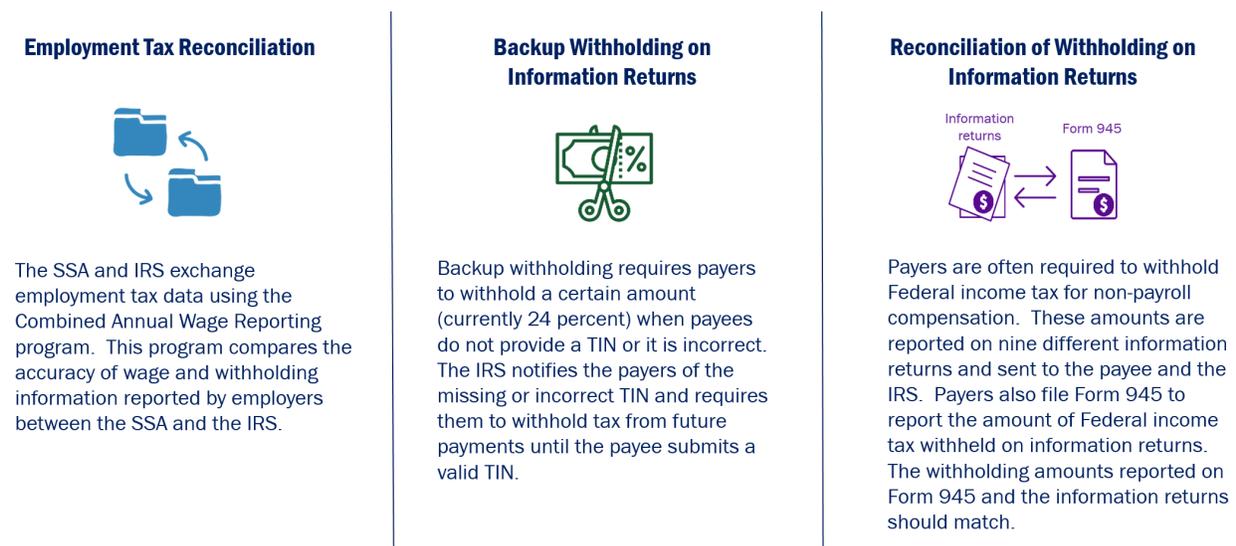
Background

The Internal Revenue Code (I.R.C.) Section (§) 3402 requires employers to withhold taxes from employees' pay so that the employers pay taxes to the Department of the Treasury on a ratable basis throughout the year. Employers use information returns, such as Form W-2, *Wage and Tax Statement*, and payers¹ use Form 1099-MISC, *Miscellaneous Income*, to report income and tax withholding. On an annual basis, employers are required to report to the Social Security Administration (SSA) wage and withholding information for each employee through a process called Annual Wage Reporting. Employers and payers are also required to report and submit to the Internal Revenue Service (IRS) Federal taxes withheld from employees using one of the following forms (collectively referred to hereafter as an employment tax return):

- Form CT-1, *Employer's Annual Railroad Retirement Tax Return*.
- Form 941, *Employer's QUARTERLY Federal Tax Return*.
- Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*.
- Form 944, *Employer's ANNUAL Federal Tax Return*.
- Form 945, *Annual Return of Withheld Federal Income Tax*.

The IRS in turn uses the data from information returns to ensure compliance with withholding rules. Figure 1 shows some of the compliance efforts and data available for reconciliation related to withholding.²

Figure 1: Compliance Efforts and Data Available for Withholding



*Source: TIGTA review of withholding procedures. TIN is defined as Taxpayer Identification Number.*³

¹ A business entity, such as a bank or financial institution, is often required to backup withhold or withhold Federal income tax when making payments to recipients.

² See Appendix III for a listing of the income documents that require backup withholding.

³ A TIN is a nine-digit numbers assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the TIN is either an Employer Identification Number, a Social Security Number, or an Individual TIN.

Results of Review

Prior Treasury Inspector General for Tax Administration (TIGTA) reviews⁴ identified that a lack of adequate processes resulted in billions of dollars in underreported taxes by employers not being addressed and taxpayers avoiding payment of billions of dollars in backup withholding.⁵ In response to recommendations included in these reviews, the IRS has taken the following actions:

- Stood up two new groups in Calendar Year 2019 to address reporting and noncompliance issues relating to backup withholding and the IRS Combined Annual Wage Reporting (IRS-CAWR) program. The IRS assigned 13 tax examiners to the backup withholding group and 14 tax examiners to the IRS-CAWR group to work issues identified for Tax Year (TY) 2017.⁶
- Updated forms, instructions, *etc.*, to include Form 1099-G, *Certain Government Payments*, in backup withholding requirements. Payers that submit a Form 1099-G with a missing or incorrect payee TIN that reports taxable grants or agricultural payments are required to backup withhold.
- Initiated various outreach efforts (*e.g.*, Tax Forum presentations) to increase awareness of backup withholding requirements and the IRS's emphasis on enforcing these requirements.
- Coordinated with the SSA to revise the *Memorandum of Understanding* regarding the transfer of employment tax data between the agencies. The revisions made were an effort to streamline the transmission of data and adjust language on how each agency can use the data.

However, our analysis of TY 2018 information return filings identified continued significant backup withholding noncompliance, with 182,075 payers not backup withholding approximately \$13.3 billion as required. We also continue to identify employment tax discrepancy cases that remain unworked. We identified 65,166 TY 2017 discrepancy cases not worked, with potential tax assessments totaling \$220 million.⁷ Another 83,570 TY 2017 discrepancy cases were also not worked, with potential tax assessments of \$2.3 billion involving employers that reported information returns to the SSA but did not file an employment tax return with the IRS (*i.e.*, nonfilers).

The noncompliance detailed above, and the IRS's lack of adequate actions to address this noncompliance, contributes to the Tax Gap, which the IRS reports is the amount of true tax

⁴ TIGTA, Ref. No. 2017-40-038, *Case Selection Processes Result in Billions of Dollars in Potential Employer Underreported Tax Not Being Addressed* (July 2017), and Ref. No. 2016-40-078, *Due to the Lack of Enforcement, Taxpayers Are Avoiding Billions of Dollars in Backup Withholding* (Sept. 2016).

⁵ There are many factors that contribute to whether backup withholding is applicable. For example, backup withholding does not apply if the payer can document that the payment was not reportable or that the payer was in possession of the payee TIN when the payments were made but failed to include it on the information return.

⁶ The tax year is a 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due.

⁷ The tax year analyzed is the most current inventory the IRS is working for employment tax discrepancies. The IRS works cases on an April through March schedule to allow time for taxpayers to file their information returns and tax returns.

liability that is not paid voluntarily and timely. The IRS's most recent estimate of the Tax Gap was \$441 billion (published in September 2019).⁸

In its April 2018 Strategic Plan,⁹ the IRS stated that one of its goals is to protect the integrity of the tax system by encouraging compliance through administering and enforcing the tax code. The IRS planned to accomplish this by creating strategies to prevent and address noncompliance in high-risk areas, developing early warning and notification systems to resolve issues faster, and sharing data and coordinating on cases within and across relevant business units. Further, the Small Business/Self-Employed (SB/SE) Division's 2019 Annual Report¹⁰ highlights goals that align with the IRS Strategic Plan. While the actions taken by the IRS fit within the goals of the strategic plans, these actions have not had a significant impact on backup withholding compliance or employer underreporting of employment taxes.

Backup Withholding Noncompliance Continues to Result in Payers Avoiding Payment of Billions of Dollars in Withholding Each Year

Since issuing our prior report in September 2016, management has made little improvement to address payers not backup withholding billions of dollars as required. [REDACTED]

[REDACTED] The requirement for backup withholding is not only outlined in the I.R.C. § 3406 but is also addressed in IRS Publication 1281, *Backup Withholding for Missing and Incorrect Names/TIN(s)*. As it relates specifically to the actions a payer should take if a payee "refuses or neglects to provide a TIN," this publication instructs payers to "begin backup withholding immediately on any reportable payments," thus reaffirming the requirements provided in the I.R.C. For TY 2018, we identified 182,075 payers that submitted 440,404 information returns for which the payee TIN was either missing¹¹ or incorrect,¹² yet the payers did not backup withhold \$13.3 billion on \$55.6 billion in reported income. Figure 2 shows the number of TY 2018 information returns with reportable payments that had a missing TIN or incorrect TIN/name combination.

⁸ The IRS estimated the average annual Tax Gap for TYs 2011 through 2013.

⁹ IRS, Publication 3744, *Internal Revenue Service Strategic Plan Fiscal Years 2018–2022* (April 2018).

¹⁰ IRS, Publication 5409, *SB/SE Division 2019 Annual Report* (June 2020).

¹¹ A missing TIN is one that is not provided, has more or less than nine numbers, or has an alpha character as one of the nine positions.

¹² An incorrect TIN is one that is in the proper format, but the name/TIN combination does not match or cannot be found on the IRS's or SSA's records.

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

Figure 2: Volume of Information Returns With a Missing or Incorrect TIN (TY 2018)

Form Type	Incorrect TIN ¹³		Missing TIN		Totals	
	Unique Payers	Number of Forms	Unique Payers	Number of Forms	Unique Payers	Number of Forms
W-2G, Certain Gambling Winnings ¹⁴	0	0	366	1,821	366	1,821
1099-B, Proceeds From Broker and Barter Exchange Transactions	1,166	71,236	131	8,666	1,297	79,902
1099-DIV, Dividends and Distributions	1,308	5,802	410	1,229	1,718	7,031
1099-INT, Interest Income	2,793	4,923	2,006	5,526	4,799	10,449
1099-MISC, Miscellaneous Income	60,093	90,930	119,962	248,765	180,055	339,695
1099-OID, Original Issue Discount	25	129	42	110	67	239
1099-PATR, Taxable Distributions Received From Cooperatives	326	627	130	464	456	1,091
1099-G, Certain Government Payments	6	140	22	36	28	176
Totals	64,298¹⁵	173,787	122,595	266,617	182,075	440,404

Source: TIGTA analysis of TY 2018 information returns.

The I.R.C. requires payers to backup withhold at a rate of 24 percent on reportable payments for a payee that refuses or neglects to provide a correct TIN

Our analysis of TY 2018 information returns identified that the number of information returns with missing or incorrect TINs, as well as the amounts not backup withheld, decreased when compared to our analysis of TY 2013 information returns in our last review.¹⁶ However, payers continue to report billions of dollars in payments without the required backup withholding. Figure 3 provides the comparison of TY 2013 to TY 2018 for information returns with missing or incorrect TINs.¹⁷

¹³ Our analysis of incorrect TINs is based upon instances in which the payer reported the same incorrect TIN for four consecutive years (TYs 2015 through 2018).

¹⁴ Form W-2G is subject to backup withholding only for missing TINs.

¹⁵ The same payer can appear in multiple information returns and missing or incorrect TIN populations; as such, the total does not sum.

¹⁶ Effective January 1, 2018, the backup withholding rate was reduced from 28 percent to 24 percent through the Tax Cuts and Jobs Act of 2017 (Pub. L. No. 115-97, 131 Stat. 2054).

¹⁷ See Appendix II for details on the outcome measures.

Figure 3: Comparison of Information Returns With Missing or Incorrect TINs for TYs 2013 and 2018

Tax Year	Number of Payers	Number of Information Returns	Reportable Payments	Backup Withholding Required	Actual Amount Withheld
Information Returns With Missing TINs					
TY 2013	130,358	310,779	\$145 billion	\$41 billion	\$5 million
TY 2018	123,069	266,617	\$44 billion	\$11 billion	\$6 million
Information Returns With Incorrect TINs¹⁸					
TY 2013	62,714	203,751	\$17 billion	\$5 billion	\$1 million
TY 2018	65,717	173,787	\$12 billion	\$3 billion	\$3 million

Source: TIGTA analysis of TY 2013 and TY 2018 information returns.

Unlike information returns with missing TINs that require payers to immediately backup withhold, payers submitting information returns with an incorrect TIN are not required to backup withhold on payments to the payee until 30 business days after the IRS notifies the payer of the incorrect payee TIN. If the IRS sends a second notice in a three-calendar-year period to the payer, backup withholding must begin 30 business days after the notice is sent and the payer does not receive a copy of the payee’s Social Security card or IRS letter validating the TIN from the payee.

Furthermore, our analysis of TY 2018 payers with missing TINs identified five payers that each should have backup withheld \$10 million or more. These payers submitted a total of 683 information returns, which accounts for \$396 million in potential backup withholding we identified. Figure 4 identifies the payers with over \$10 million in required backup withholding for TY 2018.

Figure 4: Payers With Over \$10 million in Required Backup Withholding for Missing TINs

	Total Requiring Backup Withholding	Total Income Reported	Potential Backup Withholding	Actual Backup Withholding	Potential Additional Backup Withholding Required
Payer 1	██████	██████	██████	██████	██████
Payer 2	██████	██████	██████	██████	██████
Payer 3	██████	██████	██████	██████	██████
Payer 4	██████	██████	██████	██████	██████
Payer 5	██████	██████	██████	██████	██████
Totals	683	\$1,650,543,160	\$396,130,358	\$2,142	\$396,128,206

Source: TIGTA analysis of TY 2018 information returns subject to backup withholding.

¹⁸ Our analysis of incorrect TINs is based upon instances in which the payer reported the same incorrect TIN for four consecutive years.

Functional areas initiated some efforts in an attempt to address backup withholding noncompliance, but these efforts are fragmented and inconsistent

The I.R.C. provides the IRS with the authority to hold noncompliant payers liable for amounts not withheld from payees by assessing payers the amount of backup withholding they failed to withhold.¹⁹ In addition to the noncompliance on the part of payers, enforcing payer backup withholding requirements is essential to ensuring that the Government is able to collect taxes on all appropriate income, particularly income that is not usually subject to withholding.²⁰

[REDACTED]

[REDACTED] tax revenue may be lost each year.

In our September 2016 report,²¹ we recommended that the Commissioner, SB/SE Division, establish a Service-wide information returns backup withholding enforcement strategy. This should include specific time frames and actions to identify and enforce payer noncompliance with backup withholding provisions. The IRS agreed with this recommendation and noted that it was already evaluating its backup withholding process, identifying improvement opportunities, and determining overall oversight responsibility.

Although the IRS agreed with our recommendation, our review identified that a Service-wide information returns backup withholding enforcement strategy has yet to be developed. However, we did identify that efforts are being taken by some functional areas to address this significant noncompliance, whereas other functional areas have no actions being taken. Specifically, the SB/SE Division developed a multiyear strategy in Calendar Year 2018 to address backup withholding compliance. For Calendar Year 2019, the IRS is working TY 2017 backup withholding cases for which the payer submitted information returns with missing payee TINs, [REDACTED]. To date, the IRS has mailed adjustment letters to 1,845 taxpayers. These letters notify the payer that they have filed information returns that are potentially subjected to backup withholding requirements [REDACTED].

[REDACTED] Additionally, the taxpayer is instructed on where to send [REDACTED] to resolve the potential noncompliance with backup withholding requirements. Results from these notifications remain unknown as the IRS had to halt work on these cases due to the pandemic. In addition, the strategy identifies additional actions the SB/SE Division plans to take. For example, in early Calendar Year 2021, the SB/SE Division plans to address other identified areas of noncompliance (*e.g.*, payers that submit information returns reporting backup withholding [REDACTED]).

¹⁹ I.R.C. § 3406(h)(10) states that payments which are subject to backup withholding under § 3406 are treated as if they were wages paid by the employer to an employee. Section 3403 provides that the employer shall be liable for the payment of the tax required to be deducted and withheld under Chapter 24 (collection of income tax at source on wages).

²⁰ Examples include interest income, rents, royalties, and certain gambling winnings.

²¹ TIGTA, Ref. No. 2016-40-078, *Due to the Lack of Enforcement, Taxpayers Are Avoiding Billions of Dollars in Backup Withholding* (Sept. 2016).

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

Finally, we were informed by the Tax-Exempt/Government Entities Division that processes were developed in Calendar Year 2017 to identify payers who previously received a backup withholding notice to then prioritize these cases [REDACTED]

[REDACTED] The Tax-Exempt/Government Entities Division then works the backup withholding issue on the tax account to ensure that the taxpayer is compliant with the backup withholding requirements. Alternatively, the Large Business and International Division identifies backup withholding noncompliance as part of its regular examinations and sends the employment tax issues to the SB/SE Division's Employment Tax group to address.

During our discussions with IRS management, they advised that implementation of the Taxpayer First Act²² is expected to result in a reorganization that will bring all of the IRS's examination functions under one umbrella, thus facilitating the development of a uniform compliance strategy to address backup withholding noncompliance. To that end, IRS management stated they would be developing a cross-functional working group to analyze current backup withholding policies and procedures and make recommendations to the Taxpayer First Act Office for its consideration. As such, we will not be making a formal recommendation.

Payers Continue to Report Billions of Dollars in Payments Associated With Taxpayer Identification Numbers of Deceased Individuals

Our review of TY 2018 information returns identified 52,500 payers that submitted 2.7 million information returns on 1.2 million payee TINs for which the individual was deceased at least three years prior to the issuance of the information returns. These 2.7 million information returns had reportable payments totaling \$3.7 billion; however, only \$9.5 million was withheld. Figure 6 identifies the payers with more than 50,000 information returns that used a deceased payee TIN.

Figure 6: Payers That Submitted More Than 50,000 Information Returns That Used a Deceased Payee TIN

	Total Information Returns With a Deceased TIN	Total Income Reported	Federal Tax Withheld
Payer A	154,892	\$41,869,215	\$54,030
Payer B	120,377	\$9,573,926	\$285,843
Payer C	110,076	\$107,864,538	\$208,594
Payer D	95,601	\$71,340,169	\$148,522
Payer E	91,269	\$92,041,702	\$45,078
Payer F	80,821	\$77,548,835	\$146,003

²² Pub. L. No. 116-25, 133 Stat. 981.

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

	Total Information Returns With a Deceased TIN	Total Income Reported	Federal Tax Withheld
Payer G	74,453	\$146,836,420	\$42,797
Payer H	74,367	\$133,880,477	\$689,299
Payer I	66,558	\$80,411,376	\$65,854
Payer J	51,317	\$28,927,433	\$160,858

Source: TIGTA analysis of TY 2018 information returns subject to backup withholding.

As previously stated, the IRS and SB/SE Division both have goals to advance data access, usability, and analytics to inform decision-making and improve operational outcomes. As such, the IRS should incorporate [REDACTED] to maximize its limited resources by focusing its enforcement efforts on highly noncompliant payers.

The majority of deceased payee TINs had no associated tax return reporting the income

Our analysis of the 1.2 million deceased payee TINs identified that only 59,649 (5 percent) deceased payee TINs were used to file either a Form 1041, *U.S. Income Tax Return for Estates and Trusts*; Form 1040, *U.S. Individual Income Tax Return*; or Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. The 59,649 deceased payee TINs were used on 256,068 submitted information returns with \$770 million in reportable payments.

We identified and reported this concern in our September 2016 report. Specifically, our review of TY 2013 information returns identified 2.3 million returns submitted by payers for 1.6 million individuals for whom the payee TIN was that of a deceased individual.²³ These 2.3 million information returns had reportable payments totaling \$4 billion. We recommended that the IRS:

- Include specific actions to address information return reporting of income under a deceased individual TIN. The IRS agreed with this recommendation, citing that it would include specific actions to address information return reporting under a decedent TIN as it develops the information returns compliance strategy. However, as previously noted, [REDACTED], and as such, [REDACTED]
- Add an indicator on the TIN Matching Program²⁴ alerting a payer of a payee's use of a deceased taxpayer's Social Security Number (SSN). The IRS agreed with this recommendation, stating that it would first evaluate the use of a general indicator on the TIN Matching Program without violating disclosure rules. The IRS evaluated our previous recommendation but determined that alerting a payer of a payee's use of a deceased taxpayer's SSN is an improper disclosure and violates I.R.C. § 6103. However, the IRS also recognizes the potential significance of this issue and conducted research on TY 2015 information returns with a deceased TIN. The IRS determined that, as TIGTA concluded,

²³ These individuals were deceased *at least two years* prior to the issuance of the information return.

²⁴ The TIN Matching Program is an Internet-based prefilling service that allows "authorized payers" the opportunity to match Form 1099 payee information against IRS records prior to filing information returns.

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

Management further stated that, in some cases, the payer appears to be issuing the income to the estate or trust but still using the decedent's TIN. We do agree with the IRS that use of these TINs on a Form 1099-INT or Form 1099-DIV may be associated with estates, trusts, or joint accounts held at financial institutions. The majority of the information returns we identified were either Form 1099-B, Form 1099-DIV, or Form 1099-INT. Further, it would seem less likely, and in fact suspicious, for a decedent's TIN to be used on a Form 1099-MISC or Form W-2G, which is used for reporting payments to individuals that are not employees and gambling winnings. Figure 7 shows that 169,411 Forms 1099-MISC and Forms W-2G were filed by payers using a deceased payee's TIN that had reportable payments totaling approximately \$1.7 billion and \$2.5 million in withholding. Figure 7 provides a summary of all the information returns filed using deceased payee TINs.

Figure 7: Types of TY 2018 Information Returns With Decedent TINs

	Total Information Returns With a Deceased TIN	Total Income Reported	Federal Tax Withheld
Form 1099-B	942,323	\$936,828,376	\$1,840,542
Form 1099-DIV	989,031	\$738,108,816	\$4,831,588
Form 1099-G	4,670	\$467,723	\$2,460
Form 1099-INT	573,294	\$236,574,845	\$404,292
Form 1099-MISC	168,144	\$1,671,959,147	\$2,127,660
Form 1099-OID	8,434	\$2,536,245	\$372
Form 1099-PATR	11,947	\$106,219,759	\$6,488
Form W-2G	1,267	\$3,938,167	\$323,887
Total	2,699,110	\$3,696,633,078	\$9,537,289

Source: TIGTA analysis of TY 2018 information returns subject to backup withholding.

Recommendation 1: The Deputy Commissioner for Services and Enforcement should develop processes and procedures to identify and address the reporting of income on information returns using a decedent TIN.

Management's Response: The IRS agreed with this recommendation but did not agree with the related outcome measure (see Appendix II for more detailed information on the reported outcome measure). IRS management plans to use data analytics to determine the size and scope of potential noncompliance of information returns using the SSN of a deceased person. Management will further develop processes and procedures necessary to identify and address this issue.

Due to a Programming Error, Combined Annual Wage Reporting Discrepancy Cases With the Highest Assessment Potential Are Not Selected

Our analysis of 86,538 TY 2017 IRS-CAWR discrepancy cases the IRS selected as of March 31, 2019, determined that the IRS worked 21,372 (25 percent) cases, securing tax returns or assessing additional tax totaling \$58.8 million.²⁵ The remaining 65,166 (75 percent) cases were not worked, with a potential underreported total tax difference of approximately \$220 million.²⁶ However, we identified that the IRS still did not select cases with the highest potential tax assessment. Our review of TY 2017 IRS-CAWR discrepancy cases identified 240 discrepancy cases that the IRS did not work despite the potential tax assessment amounts being higher than cases the IRS worked. The total potential tax associated with these 240 cases is \$12.1 million.

When we asked IRS management to explain why the IRS did not work the 240 discrepancy cases, management stated that there was a computer programming error that resulted in the incorrect case selection. The IRS incorrectly programmed the potential tax assessment field used to prioritize IRS-CAWR selections. After we brought this to management's attention, the IRS updated the programming to ensure that the TY 2018 discrepancy cases were selected based on the highest potential tax assessment. We reviewed the potential tax assessment field and confirmed that the IRS updated the calculation. Thus, we will not be making a recommendation. Using the IRS's corrected program to select the discrepancy cases with the highest potential tax assessment would have resulted in the IRS reviewing cases with an additional \$133.1 million in potential tax assessments.

Due to a lack of sufficient resources, the majority of nonfiler cases with potential tax assessments of \$2.3 billion are not addressed

Our review of 85,692 TY 2017 CAWR nonfiler cases²⁷ determined that the IRS worked 2,122 nonfiler cases (2 percent) and assessed a total of \$50.6 million in tax. The remaining 85,692 cases had potential tax assessments totaling \$2.3 billion. However, similar to the IRS-CAWR program, the CAWR nonfiler program does not have enough resources to work the majority of cases. The overall goal, as stated in the IRS's May 2018 SB/SE Division's Nonfiler Strategic Plan, is to prioritize work that maximizes dollars collected, which the CAWR nonfiler program appears to be following. CAWR nonfiler program employees also analyzed an additional 3,115 prior tax years related to the 2,122 TY 2017 cases and made \$67.8 million in additional tax assessments. The tax assessments for these TY 2017 and related prior year nonfiler cases totaled just over \$118 million (\$50.6 million plus \$67.8 million). IRS management stated that CAWR nonfiler cases are worked along with other inventory, and there are no specific guidelines for focusing efforts on CAWR nonfiler cases.

²⁵ In April 2020, the IRS provided the status of TY 2017 discrepancy cases worked as of the program completion date of March 2020. However, activity on cases can still occur after the program completion date.

²⁶ The IRS worked an additional 2,497 discrepancy cases after the initial selection of 86,538 discrepancy cases, which resulted in additional tax assessed or tax returns secured totaling \$5.9 million. These additional discrepancy cases were selected when exclusionary criteria no longer were applicable. For example, the disaster indicator was active during the initial selection, preventing it from being selected in the initial selection population of 86,538 discrepancy cases; however, the indicator expired and the discrepancy was selected later in the period.

²⁷ Nonfiler cases are those of payers that filed information returns but did not file their employment tax return.

The indicator that identifies a prior year employment tax discrepancy is still not used during case selection in order to maximize limited resources

We previously recommended that the IRS upgrade its system to include prior year discrepancy cases when current year discrepancy cases are selected for the same employer. The IRS disagreed with the recommendation, but stated that it planned to evaluate its methods to identify cases with the highest potential for adjustment, including the consideration of a prior year discrepancy as a selection criterion. The IRS subsequently created a repeater indicator to identify employers with both a current year and prior year discrepancy case. Additionally, there are different indicators if the repeater is in the same potential tax assessment category from year to year or in a different potential tax assessment category.

Although an indicator was developed, management stated that they do not use the indicator as part of their case selection criteria because many of the repeater cases are repeaters for different reasons (for example, the IRS identifies an employer in one year with underreported withholding tax for its employees and identifies the same employer in another year because it did not send in all its income documents). The IRS does not consider this a true repeater case because the discrepancy was not the result of the same issue. The IRS reviewed fifteen cases with a repeater indicator, which resulted in closing eight cases with no change and seven with assessments. Management stated that these repeater cases look very similar to regular IRS-CAWR discrepancy cases and felt that their normal criteria would select the highest potential assessment cases regardless of the use of the indicator.

Our analysis of the 18,822 discrepancy cases that had the repeater indicator identified that the IRS worked 4,917 (26 percent) cases with a repeater indicator and assessed \$14.2 million working the current year discrepancy case. Further analysis on the worked cases with a repeater indicator identified that the IRS only had 571 discrepancy cases (12 percent) that resulted in no assessment or no tax return secured by the IRS. Therefore, 4,346 discrepancy cases resulted in an assessment during the initial phase or in the IRS securing a tax return. Additionally, there were 13,905 discrepancy cases with a repeater indicator not worked with potential tax assessments of \$49.8 million. The IRS could use the repeater indicator as a characteristic to prioritize and select cases within each discrepancy category. For example, the IRS would work the highest potential tax assessment cases (*i.e.*, case type "A") with a repeater indicator, then the IRS would move to the highest potential tax assessment case without a repeater indicator. Thus, the IRS would prioritize first by highest potential tax assessment and then, within each case type category, prioritize cases with the repeater indicator.

In response to our concern, IRS management analyzed their TY 2017 CAWR discrepancy cases to simulate how those cases would have been prioritized using the repeater indicator. Their analysis showed that the IRS potential tax assessments would be approximately \$20 million less when prioritizing with the repeater indicator. It is important to note that the IRS's analysis was based on one tax year, and each tax year creates a different mixture of discrepancy cases. To better understand the value of adding the repeater indicator as a characteristic when prioritizing cases, the IRS should conduct an analysis, similar to the one it performed on TY 2017, of additional worked discrepancy cases (*e.g.*, TYs 2018 and 2019) to make a determination on the usefulness of the repeater indicator.

Recommendation 2: The Deputy Commissioner for Services and Enforcement should conduct an analysis (*i.e.*, similar to the one performed for TY 2017) of additional worked discrepancy

cases to determine if the repeater indicator should be used as another characteristic to prioritize IRS-CAWR discrepancy cases with the highest potential tax assessment within each case type.

Management's Response: The IRS disagreed with this recommendation. IRS management stated that TIGTA has not provided any data indicating that repeater cases are more productive or demonstrated that repeater cases yield assessments that are larger or more frequently sustained or collected. TIGTA has completed two audits of this program and has data for cases as far back as 2012. As a result of the July 2017 TIGTA report, repeater cases are marked with an indicator. Thus, TIGTA could have analyzed its own data as part of this audit to determine whether repeater cases are more productive work but has chosen not to do so. IRS management shared with TIGTA during the audit that they applied the recommended repeater criterion to TY 2017 closed cases to determine if it would have yielded more productive work; it did not. In fact, under the best case scenario, the use of that criterion would have reduced the TY 2017 potential tax assessments by approximately \$20 million. As TIGTA acknowledged in this audit and its prior audit, the CAWR program does not have enough resources to work the majority of cases, and IRS management does not believe it is a good business decision to commit to perform an additional study when TIGTA has not presented any evidence that such a study is worth the diversion of its limited resources.

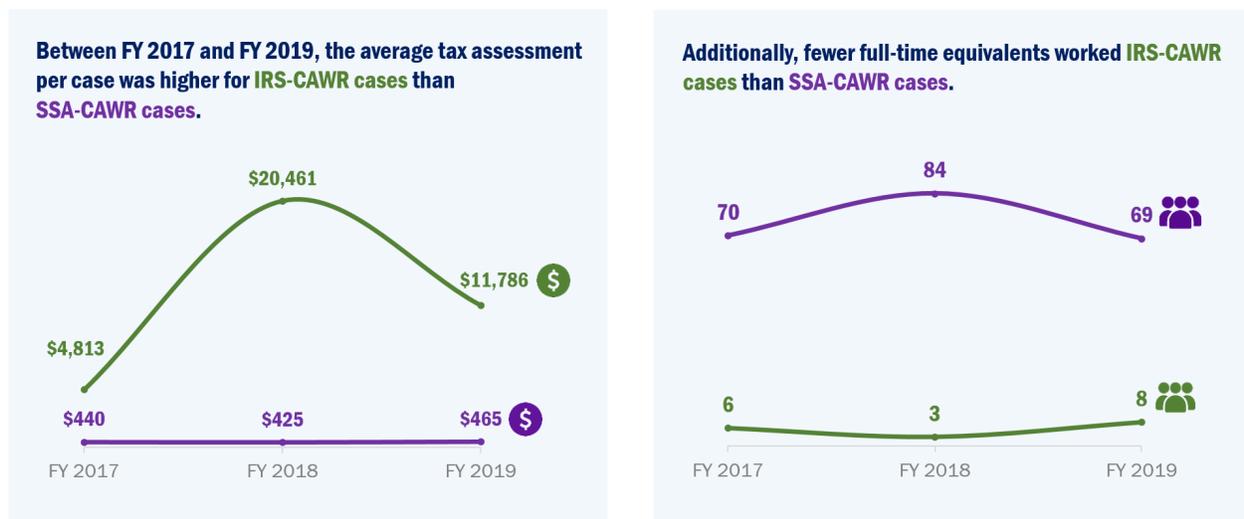
Office of Audit Comment: The two prior audits to which IRS management refers identified flaws and actions that could be taken to improve the IRS's case selection process overall. The corrective actions taken on the part of the IRS in response to our recommendations contribute to the improved performance of the IRS-CAWR program. Each of these reviews included quantitative analysis showing how the IRS's limited resources could be further maximized. Specifically, the prior report determined that prior year discrepancy cases could be included when working current year discrepancy cases for the same noncompliant employer to maximize the IRS's limited resources. In fact, the repeater indicator that management cites in its response was developed as a corrective action to address a TIGTA recommendation.

Regarding IRS management's statement that they found the use of the repeater criterion did not yield more productive work, they fail to note that this conclusion was based on the IRS's review of fifteen cases. Their determination that the indicator was not useful was based on the fact that only seven of the 15 cases resulted in an assessment for the current tax year being worked. A primary reason we reported that the indicator to identify a prior year employment tax discrepancy should be used during case selection is to maximize limited resources. It is true that just looking at TY 2017 discrepancy cases using the repeater could have resulted in less potential assessments; however, each year, the mix of discrepancy cases can change. Therefore, the repeater criterion should be evaluated over the course of several years.

Improvements Have Been Made That Provide Flexibility When Working Wage Discrepancy Cases

In our July 2017 report, we recommended that the IRS evaluate the current agreement and workload processes with the SSA, as required, and ensure that the IRS is expending resources to work the most productive SSA-CAWR cases.²⁸ Management agreed and stated that they would look for opportunities to reduce the number of SSA-CAWR cases that cannot be successfully resolved prior to referral to the IRS. Figure 8 provides a comparison of IRS resources dedicated to the SSA-CAWR program and IRS-CAWR program. Figure 8 also provides a comparison of the assessments per case for each program.

Figure 8: Comparison of IRS-CAWR and SSA-CAWR Programs for Fiscal Years (FY) 2017 Through 2019



Source: IRS report on SSA-CAWR and IRS-CAWR for Fiscal Years 2017–2019.

As part of its ongoing negotiations for a new Memorandum of Understanding, the IRS identified areas that would help improve case identification. However, when we asked IRS management if the SSA agreed to make these changes, management stated that the SSA could not currently commit to make the changes as it is in the process of a modernization effort. The SSA informed the IRS that it would consider these changes and any others the IRS identifies as they partner through the modernization effort.

As we previously reported, in April 1988, the National Committee to Preserve Social Security filed a lawsuit to force prompt resolution of the backlog of unreconciled cases (*i.e.*, wage information was not being timely recorded to earnings records) that resulted from a legislative change in the wage recording system. In addition, the lawsuit sought the adoption of measures to ensure that the problem does not recur in the future. As part of a settlement agreement resulting from the lawsuit, the IRS is required to work all SSA-CAWR cases. However, IRS Counsel recently determined that the 1988 National Committee to Preserve Social Security lawsuit settlement that resulted in the requirement that the IRS work all SSA-CAWR cases

²⁸ The SSA-CAWR program includes a reconciliation to identify discrepancies for which earnings and tax withholdings reported to the IRS on filed tax returns differs from amounts reported on Forms W-2 submitted to the SSA. A discrepancy can indicate that employees' earnings were not credited to their Social Security account.

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

expired in December 1996. As a result, the IRS plans to assign resources to the SSA-CAWR program based upon available resources and not based upon the SSA-CAWR inventory. This should provide opportunities for the IRS to refocus resources to other areas, including the IRS-CAWR program.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the IRS's progress in making improvements to its Federal tax withholding processes and procedures. To accomplish our objective, we:

- Assessed the status of the IRS's CAWR and backup withholding programs and determined if the IRS implemented recommendations from the prior audit reports.
- Assessed the status of IRS resources available to work the IRS-CAWR and backup withholding programs. We also determined if the IRS is efficiently using available resources for each program.
- Assessed the status of the IRS's information returns reporting strategy and determined if the IRS has taken appropriate actions to implement the strategy.

Performance of This Review

This review was performed with information obtained from the SB/SE Division in Covington, Kentucky, during the period August 2019 through December 2020. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Russell Martin, Assistant Inspector General for Audit (Returns Processing and Account Services); Diana Tengesdal, Director; Jonathan Lloyd, Audit Manager; Jerry Douglas, Lead Auditor; and Jerome Antoine, Auditor.

Validity and Reliability of Data From Computer-Based Systems

We relied on data extracts from the IRS of all CAWR discrepancy cases for TY 2017 and TY 2018 and from TIGTA's Data Center Warehouse¹ copy of the Information Returns Master File² for Forms 1099 and Forms W-2 for TY 2015, TY 2016, TY 2017, and TY 2018. We performed tests to assess the reliability of data extracts by: 1) reviewing the data for obvious errors in accuracy and completeness and 2) selecting a judgmental sample³ of cases from each extract to verify that the data elements extracted matched the taxpayer account information in the Integrated Data Retrieval System.⁴ We determined that the data extracts were valid and reliable for the purposes of this audit.

¹ TIGTA's centralized storage of IRS data files.

² An IRS database that contains third-party information returns documents for taxpayers, such as Forms W-2.

³ A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

⁴ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: 1) processes and procedures to ensure that employers are reporting and paying the correct amount of employment taxes, 2) processes and procedures to identify noncompliance and enforce backup withholding requirements, and 3) processes and procedures to identify information returns with decedent TINs. We evaluated these controls by reviewing policies and procedures, interviewing employees and management, and analyzing data from various sources.

Appendix II

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$604.6 million in backup withholding if the IRS held payers liable (as specified by the I.R.C.) when submitting information returns with missing payee TINs that are subject to backup withholding (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained data for TY 2018 information returns subject to backup withholding. We then identified information returns with missing payee TINs (by analyzing certain data fields) and removed information returns that were not subject to backup withholding, *e.g.*, duplicate returns, certain amended returns, foreign payers, and foreign payees.

Our review of TY 2018 information returns identified 123,069 payers that submitted 266,617 TY 2018 information returns for which the payee TIN was missing. These information returns reported payments totaling \$44 billion. As such, payers were required to immediately withhold almost \$11 billion from these payees, yet only \$6 million was withheld. I.R.C. § 3406 requires payers to backup withhold at a rate of 24 percent on reportable payments to a payee after notification that the payee TIN is missing.

After further analysis, we noted that the income amounts reported by payers significantly differed from one year to the next. Thus, similar to how we accounted for this in our prior review, we identified those payers who submitted information returns for the same payee with a missing TIN for two years in a row. Our analysis identified 12,829 payers that submitted 22,406 information returns with the same missing payee TIN, payee name, and payee zip code for two consecutive tax years (TYs 2017 and 2018). These 22,406 information returns reported payments totaling about \$2.5 billion. As such, payers were required to immediately withhold \$606,756,565, yet just \$2,130,240 was withheld. This resulted in the payers needing to report \$604,626,325 in backup withholding.

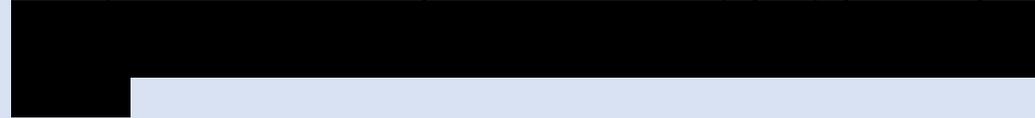
Management's Response: The IRS disagreed with this outcome measure, stating that numerous factors contribute to whether some or all of a payment is truly reportable and subject to backup withholding by a payer. For example, [REDACTED]

[REDACTED] Additionally, it cannot be assumed that income reported on an information return without a payee TIN has not been properly reported by the payee and taxed accordingly. A payer has available the Form 4669 and Form 4670 process, which may relieve the payer of the backup withholding tax liability. Lastly, the IRS has a finite amount of resources to address multiple areas of

noncompliance with competing priorities, yet TIGTA's outcome measure does not consider the opportunity costs of diverting resources from one workstream to another.

Office of Audit Comment: At a recent congressional hearing,³³ the IRS Commissioner noted that information returns are important to the IRS's ability to ensure that taxpayers pay what they owe and that this type of reporting reduces the Tax Gap. Furthermore, findings from the IRS's own Tax Gap analyses show that compliance is higher when amounts are subject to information reporting and even higher when also subject to withholding.

However, SB/SE Division's response to our report does not acknowledge that each of the information returns that we used as the basis for our outcome measure have either no TIN or an invalid TIN. As such, these information returns do not provide the IRS the ability to ensure that the taxpayers pay what they owe.



To address this, Congress enacted legislation dating back to 1983 that requires payers to backup withhold when the payee fails to provide a TIN or provides an invalid TIN. Nearly 30 years later, the IRS still does not have adequate processes/procedures to enforce backup withholding requirements. Rather than take the needed action, SB/SE Division management attempts to refute our analysis by citing unsubstantiated anecdotal scenarios that might not result in requiring backup withholding. The flaw in the management's reasoning is that none of these situations can be substantiated because these information returns have no TIN or an invalid TIN. The SB/SE Division should be in a much better position to evaluate and address this issue. Its Research Office has approximately 58 employees who can use quantitative and qualitative research techniques to provide services such as data analysis and workload selection models with a focus on data-driven results.

We note in the narrative of our outcome measure a number of factors that contribute to whether backup withholding is applicable. The fact remains there were 22,406 information returns with missing payee TINs reporting \$2.5 billion in reportable payments that required \$606.8 million to be withheld, yet only \$2.1 million was withheld. Additionally, we identified 173,787 information returns with incorrect payee TINs reporting \$11.6 billion in reportable payments that required \$2.8 billion to be withheld, yet only \$2.6 million was withheld. This directly impacts the Tax Gap and the IRS is not taking sufficient actions to address the problem.

Finally, we fully acknowledge the IRS's resource limitation and our report includes analyses that could be performed to identify the most egregious noncompliant payers. The results of these analyses are on pages 3 through 6.

³³ Senate Finance Committee Hearing on 2021 Tax Filing Season, April 13, 2021.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$2.8 billion in backup withholding if the IRS held payers liable (as specified by the I.R.C.) when submitting information returns with incorrect payee TINs that are subject to backup withholding (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained data for TYs 2015, 2016, 2017, and 2018 information returns potentially subjected to backup withholding. We then identified information returns with incorrect payee name/TIN combinations (by analyzing certain data fields) and removed information returns not subject to backup withholding, *e.g.*, duplicate returns, certain amended returns, foreign payers, and foreign payees.

Our review of TY 2018 information returns identified 65,717 payers that submitted 173,787 information returns for which the payer used the same incorrect payee TIN for four consecutive years (TYs 2015 through 2018). These information returns reported payments totaling \$11.6 billion in TY 2018. As such, payers were required to withhold nearly \$2.8 billion from these payees, yet only \$2.6 million was withheld. I.R.C. § 3406 requires payers to backup withhold at a rate of 24 percent on reportable payments to a payee after notification that the payee TIN is incorrect. This resulted in the payers needing to report \$2,770,804,013 in backup withholding.

Unlike information returns with missing TINs that require payers to immediately backup withhold, payers are not required to backup withhold on payments to the payee until 30 business days after the IRS sends the payer correspondence notifying them of an incorrect payee TIN. If the IRS sends a second notice in a three-calendar-year period to the payer, backup withholding must begin 30 business days after the notice is sent and the payer does not receive a copy of the payee's Social Security card or IRS letter validating the TIN from the payee.

IRS management indicated there are a number of factors that contribute to whether backup withholding is applicable. For example, taxpayers may use the Form 4669 and Form 4670 process that relieves the payer from their backup withholding liabilities. Additionally, it is possible that income reported on an information return with a missing payee TIN may have in fact been reported to the IRS on a subsequent information return with the correct payee TIN and taxed accordingly. Furthermore, [REDACTED]

Management's Response: The IRS disagreed with this outcome measure, stating that numerous factors contribute to whether some or all of a payment is truly reportable and subject to backup withholding by a payer. For example, [REDACTED]

[REDACTED] Additionally, it cannot be assumed that income reported on an information return with an incorrect TIN has not been properly reported by the payee and taxed accordingly. A payer has available the Form 4669 and Form 4670 process, which may relieve the payer of the backup withholding tax liability. As noted in TIGTA's report, the IRS is already addressing backup withholding in field

examinations as well as in its campus operations. Specifically, TIGTA acknowledges that the IRS is working TY 2017 backup withholding cases in which [REDACTED]

[REDACTED] To date, these efforts have resulted in adjustment letters to 1,845 taxpayers. The Tax Exempt and Government Entities Division has also been working these cases for two years. Both the SB/SE and Tax Exempt and Government Entities Divisions are working field examinations addressing backup withholding. These programs have already started addressing TY 2018 cases. TIGTA also assumes that the IRS has resources available to address 100 percent of these returns. The IRS has a finite amount of resources to address multiple areas of noncompliance with competing priorities. TIGTA's outcome measure does not consider the opportunity costs of diverting resources from one workstream to another.

Office of Audit Comment: See the Office of Audit Comment in response to the IRS's disagreement to the first outcome measure.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 2.4 million information returns submitted with deceased individuals' TINs as the payee TINs (see Recommendation 1).

Methodology Used to Measure the Reported Benefit:

We obtained data for TY 2018 information returns subject to backup withholding. We then identified information returns with payee TINs of deceased individuals by analyzing the SSA file that includes dates of death. We identified forms issued to payees who had been deceased for at least three years (since December 31, 2015). We arbitrarily chose three years as we thought this was sufficient time to allow the IRS to update its systems for these decedent TINs.

Our review of TY 2018 information returns subject to backup withholding found that the IRS received 2,699,110 returns from 52,500 payers totaling \$3.7 billion in reportable payments for 1.2 million deceased individuals who were deceased three years prior to the information return reportable payments; therefore, we assume the income likely does not belong to the taxpayer.

We also analyzed IRS tax records to determine if the 1.2 million decedent payee TINs were used to file TY 2018 tax returns to claim the income reported on the information returns. Our analysis identified that 59,649 decedent TINs were used to file either a Form 1041, Form 1040, or Form 706. The 59,649 deceased payee TINs submitted 256,068 information returns with \$770 million in reportable payments. As a result, 1.1 million decedent TINs used on 2,443,042 (2,699,110 – 256,068) information returns were not used to file a Form 1041, Form 1040, or Form 706 to claim the reportable payments on the information returns.

Generally, payers should not submit information returns using the SSN of a deceased taxpayer for identification of the payee. These taxpayers have been deceased for three or more years and thus are likely being used because payers have not been notified about the death of a payee, an estate EIN has not been provided to the payer, or payees are providing the [REDACTED]

Management's Response: The IRS disagreed with this outcome measure, stating that the SSN of a deceased person is not an invalid TIN and can be reflected on information returns in accordance with information return filing guidelines. IRS management

believes TIGTA wrongly states, "Generally, payers should not submit information returns using the TIN of a deceased taxpayer for identification of the payee." If the payer has not been notified of a change in name or TIN, by either the payee or the IRS, the payer is in compliance as long as it is filing information returns on time and using a valid TIN. TIGTA also did not thoroughly analyze if this income was reported elsewhere. The report observes that information returns report income associated with TINs of deceased taxpayers that are not associated with filed Forms 1040. However, [REDACTED]

TIGTA also failed to check for this income being reported on any surviving spouse's Form 1040.

Office of Audit Comment: SB/SE Division management's response mischaracterizes our report. TIGTA did not state that these are invalid SSNs. In fact, the IRS previously agreed with our conclusion that there is no clear way to match the information returns to income reported for a deceased payee TIN. Our reviews continually show that billions of dollars in income are being reported for individuals who have been deceased for more than two years.

Furthermore, SB/SE Division management's response acknowledges the overall risk to tax administration involved with the use of a decedent's TIN. To address this risk, the IRS's systems [REDACTED]

[REDACTED] Nonetheless, SB/SE management has not taken any steps to address the potential fraud associated with the \$770 million in reportable payments under a decedent's TIN.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$133.1 million in additional tax assessments from IRS-CAWR discrepancy cases with the highest potential for assessment not worked by the IRS (see page 11).

Methodology Used to Measure the Reported Benefit:

Our review of TY 2017 IRS-CAWR discrepancy cases shows that the IRS is still not selecting discrepancy cases with the highest potential for assessment. The IRS selected and worked 21,372 TY 2017 IRS-CAWR discrepancy cases resulting in securing tax returns or assessing additional tax totaling \$58.8 million. The IRS worked an additional 2,497 discrepancy cases after the initial selection of 86,538 discrepancy cases, which resulted in additional tax assessed or tax returns secured totaling \$5.9 million. Our review of TY 2017 IRS-CAWR discrepancy cases identified 240 discrepancy cases for which the IRS-CAWR program did not work the case despite the potential tax assessment being greater than cases the IRS worked. The total potential tax associated with these 240 discrepancy cases is \$12.1 million. The IRS confirmed that a programming error resulted in the IRS not selecting TY 2017 cases by the highest potential tax assessment as was intended. This resulted in the IRS not working potentially \$133,071,799 in additional tax assessments. We calculated the outcome by taking the difference between what the IRS could have assessed (\$197,722,352) and what the IRS actually assessed through securing

tax returns or assessing additional tax (\$58,778,182) and additional discrepancy cases worked after initial population (\$5,872,371).

Management's Response: The IRS disagreed with this outcome measure, stating that TIGTA incorrectly assumes 100 percent of the potential tax assessments would be realized in every case. The IRS informed TIGTA that this assumption is wrong. Numerous factors contribute to whether some or all of a potential discrepancy is fully assessable. TIGTA's outcome measures do not take into consideration cases that are worked correctly yet result in no tax or a reduced tax assessment. Datasets provided by TIGTA contained 23,865 cases that showed current case status. However, these datasets did not include dollars associated with these categories of cases, so IRS management can only make the following general observations: Of the 23,865 returns, 12 percent (2,732) of the closed work has been reconsidered after initial assessment and generally would indicate that the ultimate assessment was lower than the amount originally proposed. An additional subset of 15,449 (65 percent) cases requires rework and has the potential for a similar outcome (*i.e.*, reduced assessment). Only 17 percent (4,250) of the returns identified by TIGTA resulted in a full agreement or a return being secured that could equal the full potential tax assessment. TIGTA's outcome measure also assumes that the IRS has unlimited resources and does not take into account our finite resources and the opportunity costs of diverting resources from one workstream to another.

Office of Audit Comment: Data for the 23,865 cases that IRS management refers to in its response were provided by the IRS, and we used that data to identify the 21,372 discrepancy cases the IRS selected and worked that are claimed in this outcome measure. The outcome measure reflects the potential tax assessment that relates to a programming error we brought to IRS attention where the IRS did not select discrepancy cases with the highest potential tax assessment. This programming error resulted in the IRS selecting discrepancy cases with lower potential tax assessments, which resulted in a potential \$133.1 million of additional tax assessments that we report in this outcome measure.

Management again cites its resource limitations; however, the programming error resulted in the IRS selecting and working cases with a low potential tax assessment. If this programming error did not occur, the IRS could have worked a more productive mixture of discrepancy cases focusing on the highest potential tax assessment, which maximizes the use of these limited resources.

Appendix III

Information Returns Requiring Backup Withholding

Form 1099-B	Brokers and Barter Exchanges
Form 1099-DIV	Dividends and Distributions
Form 1099-G	Certain Government Payments
Form 1099-INT	Interest Income
Form 1099-K	Payment Card and Third Party Network Transactions
Form 1099-MISC	Miscellaneous Income
Form 1099-OID	Original Issue Discount
Form 1099-PATR	Taxable Distributions Received from Cooperatives
Form W-2G	Gambling Winnings ¹

¹ Form W-2G is subject to backup withholding only for missing TINs.

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

April 8, 2021

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: De Lon Harris 
Commissioner, Small Business/Self-Employed Examination

SUBJECT: Draft Audit Report – Backup Withholding Noncompliance and
Underreported Employment Taxes Continue to Contribute
Billions of Dollars to the Tax Gap (Audit # 20190028)

Thank you for the opportunity to review the above subject draft audit report. We want to state upfront that we take exception to the title of this report. It misleads the reader, and as discussed below, does not take into account the impact of our significant actions in each program. Furthermore, it potentially overstates the effect on the tax gap by assuming that income reported on an information return without a payee TIN has not been properly reported by the payee and taxed accordingly. Finally, we informed you during the audit that we disagree with your assumption that 100% of the potential tax assessments would be realized in every case. Accordingly, we disagree with your outcome measure regarding additional tax assessments from IRS-CAWR Program.

This report addresses two distinct compliance areas for income reported and paid to individuals: backup withholding non-compliance and employment tax discrepancies.

Backup Withholding Non-Compliance

Backup withholding helps to ensure that the government can collect taxes on all appropriate income, particularly income that is not usually subject to withholding. Payers of certain income types must deduct and withhold tax if certain criteria are not met. For example, a payer may be liable for backup withholding when a payee fails to furnish a correct Taxpayer Identification Number (TIN) to the payer.

We have taken many steps in recent years to improve our backup withholding program. For example, we:

- Conducted an evaluation of the backup withholding processes, identified areas for improvement, and took action to address those areas.
-

Backup Withholding Noncompliance and Underreported Employment Taxes Continue to Contribute Billions of Dollars to the Tax Gap

2

- Established a new field compliance function to address backup withholding and developed training and authoritative documentation to support the function.
- Conducted outreach to increase awareness of backup withholding requirements.

We disagree with your assessment that our efforts have made little improvement. Figure 3 in the report shows that the number of information returns with missing or incorrect TINs has decreased by nearly 75,000 between Tax Year 2013 and 2018. Further, the backup withholding required with respect to these information returns decreased by \$32 billion while the actual amounts withheld increased by \$3 million for the same time period.

We believe that you continue to overstate backup withholding noncompliance. Numerous factors contribute to whether some or all of a payment is truly reportable and subject to backup withholding by a payer. It cannot be assumed that income reported on an information return with an incorrect payee TIN has not been properly reported by the payee and taxed accordingly. A payer may be relieved of the backup withholding tax liability if it can document on Forms 4669 and 4670 that the payee has reported the payment and paid the tax.

Employment Tax Discrepancies

Employers must generally withhold taxes from employee's wages and report withholding information to the Social Security Administration and the IRS. We identify employment tax discrepancies through the Combined Annual Wage Reporting (CAWR) program. The CAWR program also systemically identifies employment tax return non-filers and refers this work for compliance action outside of the CAWR program.

As with backup withholding, we strive to continuously improve our employment tax discrepancies programs:

- Even with reduced resources, we increased the percentage of CAWR cases worked between 2013 and 2017 by 3%.
- We established a new group to work certain CAWR inventory.
- We partnered with SSA to streamline transmission of data between our agencies and modify how the data can be used.

It is important to note that we also established the "repeater" indicator to identify employers with both a current year and prior year discrepancy case after your 2017 audit. As we shared with you during this audit, we applied the recommended "repeater" criterion to our tax year (TY) 2017 closed cases to determine if it would have yielded more productive work; it did not. In fact, under the best-case scenario, the use of that criterion would have reduced the TY 2017 potential tax assessments by approximately \$20 million.

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

3

In addition to the items listed above, SB/SE is taking action to address employers who use one EIN for their tax return and a different EIN for associated information returns. These mismatches make it difficult to use data analysis to validate return data for compliance purposes. To improve detection of non-compliance by both our backup withholding and CAWR programs, we are implementing a requirement that taxpayers report and remit taxes using the same EIN they used on any associated information returns (e.g. Forms 1099-MISC) and Forms W-2, *Wage and Tax Statement and Form* and W-3, *Transmittal of Wage and Tax Statements*. We revised the TY 2020 forms and instructions as needed, and Form 945, *Annual Return of Withheld Federal Income Tax*; Form 941, *Employer's Quarterly Federal Tax Return*; Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*; and Form 944, *Employer's Annual Federal Tax Return* all instruct taxpayers of this "same EIN" requirement. We have developed a communications plan to ensure that the "same EIN" policy is communicated to impacted taxpayers and are currently working with our research function to identify potential recipients of compliance notices and refine next steps.

In conclusion, you have conducted multiple audits and made several recommendations for these programs in recent years. We have taken actions to implement substantially all those recommendations. We have also independently identified and are pursuing improvements to both the backup withholding and employment tax discrepancy programs. You continue to disregard our limited resources and competing compliance priorities when evaluating our programs.

Attached is a detailed response outlining our corrective actions to address your recommendations and outcome measures. If you have any questions, please contact me or Scott Irick, Director, Examination Operations.

Attachment

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

Attachment

RECOMMENDATION 1:

The Deputy Commissioner for Services and Enforcement should develop processes and procedures to identify and address the reporting of income on information returns using a decedent taxpayer identification number (TIN).

CORRECTIVE ACTION:

We will use data analytics to determine the size and scope of potential non-compliance of information returns using the Social Security number (SSN) of a deceased person and determine what processes and procedures, if any, can be developed to address the issue.

IMPLEMENTATION DATE:

10/15/2022

RESPONSIBLE OFFICIAL:

Director, SB/SE HQ Exam

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

The Deputy Commissioner for Services and Enforcement should conduct an analysis (*i.e.*, similar to the one performed for TY 2017) of additional worked discrepancy cases to determine if the repeater indicator should be used as another characteristic to prioritize IRS-CAWR discrepancy cases with the highest potential tax assessment within each case type.

CORRECTIVE ACTION:

TIGTA has not provided any data indicating “repeaters” are more productive cases. TIGTA has not demonstrated “repeaters” yield assessments that are larger or more frequently sustained or collected as compared to non-repeaters. TIGTA has completed two audits of this program and has data for cases as far back as 2012. As a result of the prior 2017 TIGTA audit, “repeater” cases are marked with an indicator. Thus, TIGTA could have analyzed its own data as part of this audit to determine whether “repeaters” are more productive work but has chosen not to do so. As we shared with TIGTA during this audit, we applied the recommended “repeater” criterion to our TY 2017 closed cases to determine if it would have yielded more productive work; it did not. In fact, under the best-case scenario, the use of that criterion would have reduced the TY 2017 potential tax assessments by approximately \$20 million. As TIGTA has acknowledged in this audit and its prior audit, the CAWR program does not have enough resources to work the majority of cases, and we do not believe it is a good business decision to

**Backup Withholding Noncompliance and Underreported Employment
Taxes Continue to Contribute Billions of Dollars to the Tax Gap**

2

commit to perform an additional study when TIGTA has not presented any evidence that such a study is worth the diversion of our limited resources.

IMPLEMENTATION DATE

NA

RESPONSIBLE OFFICIAL:

NA

CORRECTIVE ACTION MONITORING PLAN:

NA

OUTCOME MEASURE 1:

Revenue Potential: \$604.6 million in backup withholding if the IRS held payers liable (as specified by the I.R.C.) when submitting information returns with missing payee TINs that are subject to backup withholding (see page 3).

IRS RESPONSE:

We disagree with this measure. Numerous factors contribute to whether some or all of a payment is truly reportable and subject to backup withholding by a payer. For example,

[REDACTED]

Additionally, it cannot be assumed that income reported on an information return without a payee TIN has not been properly reported by the payee and taxed accordingly. A payer has available the Form 4669 and Form 4670 process, which may relieve the payer of the backup withholding tax liability. Lastly, the IRS has a finite amount of resources to address multiple areas of noncompliance with competing priorities, yet TIGTA's outcome measure does not consider the opportunity costs of diverting resources from one workstream to another.

OUTCOME MEASURE 2:

Revenue Protection – Potential; \$2.8 billion in backup withholding if the IRS held payers liable (as specified by the I.R.C.) when submitting information returns with incorrect payee TINs that are subject to backup withholding (see page 3).

IRS RESPONSE:

We disagree with this outcome measure. Numerous factors contribute to whether some or all of a payment is truly reportable and subject to backup withholding by a payer. For example,

[REDACTED]

Additionally, it cannot be assumed that income reported on an information return with an incorrect payee TIN has not been properly reported by the payee and taxed accordingly.

A payer has available the Form 4669 and Form 4670 process, which may relieve the payer of the backup withholding tax liability.

As noted in TIGTA's report, the IRS is already addressing backup withholding in field examinations as well as in our campus operations. Specifically, TIGTA acknowledges that the IRS is working "TY 2017 backup withholding cases where the [REDACTED]

[REDACTED] To date, these efforts have resulted in adjustment letters to 1,845 taxpayers." TE/GE has also been working these cases for two years. Both SB/SE and TE/GE are working field examinations addressing backup withholding. These programs have already started addressing 2018 cases.

TIGTA also assumes that the IRS has resources available to address 100% of these returns. The IRS has a finite amount of resources to address multiple areas of noncompliance with competing priorities. TIGTA's outcome measures do not consider the opportunity costs of diverting resources from one workstream to another.

OUTCOME MEASURE 3:

Reliability of Information – Potential; 2.4 million information returns submitted with deceased individuals' TINs as the payee TINs (Recommendation 1).

IRS RESPONSE:

We disagree with this outcome measure. The SSN of a deceased person is not an invalid TIN and can be reflected on information returns in accordance with information return filing guidelines. TIGTA wrongly states, "Generally, payers should not submit information returns using the TIN of a deceased taxpayer for identification of the payee." If the payer hasn't been notified of a change in name or TIN, by either the payee or the IRS, the payer is in compliance as long as it is filing information returns on time and using a valid TIN.

TIGTA also did not thoroughly analyze if this income was reported elsewhere. The report observes that information returns report income associated with TINs of deceased taxpayers that are not associated with filed Forms 1040. However, TIGTA

[REDACTED] TIGTA also failed to check for this income being reported on any surviving spouse's Forms 1040.

OUTCOME MEASURE 4:

Increased Revenue – Potential; \$133.1 million in additional tax assessments from IRS-CAWR discrepancy cases with the highest potential for assessment not worked by the IRS (see page 9).

IRS RESPONSE:

We disagree with this outcome measure. TIGTA incorrectly assumes 100% of the potential tax assessments would be realized in every case. The IRS informed TIGTA that this assumption is wrong. Numerous factors contribute to whether some or all of a potential discrepancy is fully assessable. TIGTA's outcome measure does not take into consideration cases that are worked correctly yet result in no tax or a reduced tax assessment. Datasets provided by TIGTA [in support of this outcome measure?] contained 23,865 cases that showed current case status. However, these datasets did not include dollars associated with these categories of cases, so we are able to only make the following general observations: Of the 23,865 returns, 12% (2,732) of the closed work has been reconsidered after initial assessment and generally would indicate that the ultimate assessment was lower than the amount originally proposed. An additional subset of 15,449 (65%) cases requires rework and has the potential for a similar outcome (i.e., reduced assessment). Only 17% (4,250) of the returns identified by TIGTA resulted in a full agreement or a return being secured that could equal the full potential tax assessment.

TIGTA's outcome measure also assumes that the IRS has unlimited resources and does not take into account our finite resources and the opportunity costs of diverting resources from one workstream to another.

Abbreviations

CAWR	Combined Annual Wage Reporting
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
SSA	Social Security Administration
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TY	Tax Year



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