Initial Electronic Filing of Large Partnership Returns Was Successful, but Additional Checks Are Needed to Ensure the Accuracy of Information From These Returns Used in Matching Programs

September 2001

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 19, 2001

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Initial Electronic Filing of Large Partnership Returns Was Successful, but Additional Checks Are Needed to Ensure the Accuracy of Information From These Returns Used in Matching Programs

This report presents the results of our review to determine whether:

- Preparations were made to ensure timely and accurate processing of electronically filed U.S. Return of Partnership Income (Forms 1065) and related Partner's Share of Income, Credits, Deductions, etc. (Schedules K-1), in compliance with the modified requirements of the Taxpayer Relief Act of 1997[1] (TRA).
- The Internal Revenue Service (IRS) would be able to process the numbers of Forms 1065 and related Schedules K-1 projected by the Electronic Tax Administration (ETA) Strategic Plan for Tax Year 2000.

In summary, we found the processing of electronically filed partnership returns has been successfully implemented. However, additional controls should be developed to increase the accuracy of information provided by taxpayers on electronic partnership returns, which could improve the success of subsequent matching programs. Implementing our recommendation would allow inclusion of approximately 204,000 partnership Schedules K-1 in the IRS matching program. Otherwise, these information returns would be unusable.

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[1] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 app.).

Management’s response was due on September 14, 2001. As of September 17, 2001, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have any questions or your staff may call Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Initial Electronic Filing of Large Partnership Returns Was Successful, but Additional Checks Are Needed to Ensure the Accuracy of Information From These Returns Used in Matching Programs

Background

Over 1.8 million partnerships with over 18 million partners are expected to file tax returns during 2001. Internal Revenue Service (IRS) data from Tax Year 1998 indicated that partnerships accounted for $297 billion in net income and $111 billion in net losses which, in turn, flowed through to both individual and business taxpayers.

The Taxpayer Relief Act of 1997[1] (TRA) required partnerships with more than 100 partners to file their U.S. Return of Partnership Income (Form 1065) and related Partner's Share of Income, Credits, Deductions, etc. (Schedule K-1) electronically. The Congress originally wanted this provision of the TRA to be effective for all partnership tax returns filed for tax years beginning after December 31, 1997. Despite this and the IRS' goal to have 80 percent of all tax returns filed electronically by 2007, the IRS postponed implementation of this provision until 2001. The IRS postponed implementation to allow partnerships additional time to develop systems that accommodate IRS processing requirements and to avoid interfering with partnerships' efforts to address year 2000 computer problems. During 2000, the IRS accepted voluntarily filed electronic Forms 1065 but did not mandate them for partnerships with more than 100 partners.

Historically, electronically filed documents have had accuracy rates greater than those for paper documents. The IRS and the Department of the Treasury believe that electronic filing places fewer burdens on taxpayers than filing using other forms of magnetic media.

Under proposed regulations, partnerships exceeding 100 partners that fail to file their returns electronically will be subject to the information reporting penalty provisions. Penalties for failure to file information returns electronically apply for each Schedule K-1.

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[1] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 app.).

Also significant to this issue is the IRS' goal of increasing compliance among individual taxpayers receiving income, credits, and other distributions from partnerships, Subchapter S Corporations, and estates and trusts that report this information on Schedules K-1. The IRS has committed significant funds from the Fiscal Year 2001 Staffing Tax Administration for Balance and Equity (STABLE) initiative to process an estimated 29.5 million electronic and paper Schedules K-1. STABLE funds will be used to match these Schedules K-1 to individual tax returns in the IRS Underreporter Program. Many stakeholders have expressed concerns with the accuracy of these matches.

The IRS' Tennessee Computing Center (TCC) will receive all electronically filed Forms 1065 and related Schedules K-1. Staff at six IRS Submission Processing Centers operate the Underreporter Program.

Our audit was conducted at the Ogden Submission Processing Center, the TCC, and the Electronic Tax Administration at the National Headquarters from November 2000 to May 2001. This audit was performed in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I.

Controls Are Generally Adequate to Ensure Proper Processing of Electronic Partnership Returns

The IRS had to take a number of actions to prepare for the electronic filing of partnership returns and Schedules K-1. For example, IRS personnel prepared programming requests to ensure that all changes to Tax Year 2000 forms related to partnership returns would be accepted electronically and that IRS computers could identify those partnerships having over 100 partners that did not file electronically and did not have proper waivers. To electronically process these partnership returns, the Electronic Tax Administration (ETA) function in the Wage and Investment Division needed to ensure 61 separate forms and related schedules, as well as statement and summary records, were up-to-date and accurate. Systems Acceptability Testing (SAT) was successfully completed in mid-February, and the ETA function accepted and electronically processed the first Tax

Year 2000 Forms 1065 and related schedules on February 22, 2001.

The processing was successful. The IRS had processed over 5,600 Forms 1065 and approximately 600,000 related partners' Schedules K-1 filed electronically as of May 2, 2001. Processing error rates for the returns that passed initial validation checks and were accepted into the IRS electronic filing system were approximately one-half of 1 percent. Further, as of April 26, 2001, the IRS had received only 236 requests for waivers from the electronic filing requirement.

The ETA function's estimates of the number of partnership returns required to file electronically appeared to be reasonable. However, since this is the first required year of the program, and some taxpayers not required to file electronically may do so voluntarily while others required to file electronically may request waivers, the IRS could not predetermine the number of electronic filers with real certainty. In fact, partnership returns successfully processed, as of May 2, 2001, exceed the original projections for the entire processing year.

Overall, the IRS had implemented controls to properly accept and process electronically filed Forms 1065 and related Schedules K-1.

Controls Are Needed to Improve the Accuracy of Information on Electronic Forms 1065 and Schedules K-1

Stakeholders have expressed concerns about the IRS' plans to improve compliance for taxpayers receiving income, credits, and other distributions from partnerships, Subchapter S Corporations, and estates and trusts by matching data reported by these entities to taxpayers' individual income tax returns. One concern is the accuracy of the data.

Electronically filed returns have the potential for being more accurate than paper returns because the IRS can perform certain validity checks prior to accepting the returns. To improve the accuracy of taxpayer identifying data, the IRS could automatically determine if partnership and partner taxpayer identification numbers are valid. IRS data showed Schedules K-1 filed electronically with Forms 1065 during

2000 were not always reliable. Specifically, over 34 percent of the Schedules K-1 contained invalid taxpayer identification numbers. To improve the accuracy of partners' tax information, the IRS could implement controls to ensure data, such as ordinary income figures on page 1 of the Form 1065, or capital gains, contributions, and various credits from Schedule K of the Form 1065, are in agreement with the sum of corresponding figures reported on the individual Schedules K-1.

The Congress has directed the IRS to increase the number of taxpayers filing their tax returns electronically. Placing accuracy requirements on electronic returns that are not required of paper returns could negatively affect this goal. Because of this, the IRS has been hesitant to program some controls to ensure the accuracy of information filed on electronic Forms 1065 and Schedules K-1. For example, the Director, Diversified Electronic Filing, expressed the opinion that it would not be practical to reject an electronically filed partnership return having several thousand partners simply because a small number of Schedules K-1 have incorrect taxpayer identification numbers. We agree but also believe that a check like this could be used to improve the compliance and accuracy of the data. The IRS could establish a tolerance based on the total number of Schedules K-1 filed and the number of invalid Schedules K-1 submitted, or it could provide feedback to partnerships regarding the accuracy of the information submitted. The possibility of subsequent penalties could be an incentive to improve the accuracy of this significant payee information.

The IRS matching program will compare what the partnerships report on their Schedules K-1 with what the partners report on their personal or corporate tax returns. If significant numbers of partnerships are excluded from matching programs, IRS resources will not be fully utilized. If tax data is not accurate, the IRS goal for improved compliance may not be completely realized.

Implementing our recommendation would allow inclusion of approximately 204,000 partnership Schedules K-1 in the IRS matching program that otherwise would be unusable.

Recommendation

1. The ETA function, along with the Compliance function of the Small Business/Self-Employed Division and the Pre-Filing and Technical Guidance function of the Large and Mid-Size Business Division, should develop controls to ensure the accuracy of Forms 1065 and Schedules K-1 and improve the success of the matching programs. Primary consideration should be validity checks for taxpayer identification numbers on Forms 1065 and Schedules K-1 and checks to ensure tax data from Forms 1065 are in agreement with the sum of corresponding figures reported on the individual Schedules K-1.[2]

Management's Response: Management's response was due on September 14, 2001. As of September 17, 2001, management had not responded to the draft report.

Computer Programming Needed Correction to Ensure Accurate Partnership Capital Account Information Posted to the Business Masterfile

Most information from electronically filed Forms 1065 posted accurately to the IRS' Business Masterfile.[3] The accuracy of information posting to the Business Masterfile is essential to the effectiveness of some IRS programs. For example, the IRS uses information from the Business Masterfile to select tax returns for compliance programs.

One of the items from Form 1065 that the IRS captures for future use is the ending balance of the Partners' Capital

[2] There are certain returns, specifically Publicly Traded Partnerships, for which the Form 1065 may not be in agreement with the Schedules K-1. This is because brokerage firms use nominee accounts for reporting purposes, which can result in over-reporting. However, these Publicly Traded Partnerships are easily identified and provisions could be made to program exception criteria for these returns.

[3] The IRS' Masterfile is its main computer system; it contains taxpayer records.

Account, Schedule M-2, line 9. However, IRS computer programs written to capture this information on the Business Masterfile recorded incorrect amounts. In a judgmental sample of 30 early filed electronic Forms 1065, there were 27 returns with entries on this line. The information reflected on the Business Masterfile for this line on all 27 returns was incorrect. In each case, the amount from another line of the return was captured.

Pertinent lines on electronic Forms 1065 are assigned field names/numbers to facilitate their accurate input into the IRS' computers. The field number for Schedule M-2, line 9 changed for Tax Year 2000. However, the IRS' computer programs did not account for this change. SAT testing did not identify this error because IRS personnel do not verify amounts posting to the Business Masterfile during SAT testing.

When we identified this problem, we informed IRS analysts and programmers. They immediately updated computer programs to correct it. Otherwise, taxpayer compliance programs would be relying on incorrect information, which could cause taxpayers unnecessary burden and result in inefficient use of IRS compliance resources.

Estimates of the Partnership Returns to Be Filed Electronically Appeared Reasonable, but Filing Patterns Needed to Be Considered in Capacity Studies

The Electronic Management System (EMS) is an integrated set of systems and processes designed to securely process electronic tax information. The IRS contracted with the MITRE Corporation to evaluate the adequacy of the EMS communications and processing resources to accommodate the 2000 filing season[4] workload. In defining the workload, the MITRE study stated Form 1065 processing occurs from April to October and, thus, can be ignored. ETA function management also expressed the opinion that most large partnerships (more than 100 partners) file their tax returns in October. The ETA needed accurate estimates of the volumes and timing of the filing of electronic partnership

[4] The term "filing season" refers to the period from January through mid-April of each year, during which the majority of individual tax returns are filed.

returns to make sound decisions regarding the adequacy of the EMS and processing resources.

IRS data showed that the ETA function’s estimates of the total number of large partnerships required to file electronically were reasonable. The IRS’ Office of Research projected the number of Forms 1065 and Schedules K-1 required to be filed electronically for Tax Year 2000 were 4,400 and 4,786,000, respectively. However, historical filing patterns indicated the IRS could receive more returns by the end of April than expected.

During 2000, approximately one-third of all large partnership returns were filed by April. In addition, the majority of all (not just large) partnership returns were received during April. In the past, the IRS stored many of these paper returns as they were filed and processed them later in the year after peak processing periods. Because of this, management may not have considered the need to include these returns in the MITRE communications/ capacity study data. This could have affected the accessibility of the EMS to partnership filers.

We brought this filing pattern issue to the attention of ETA function management in February 2001. They took immediate corrective action. Prior to the April peak, Information Technology Services (ITS) personnel conducted an outreach with large filers to ensure they employed compression and format techniques to significantly reduce file size and the duration of transmissions. ITS personnel also developed plans to modify the system configuration to provide additional system resources should the volume or duration of electronic transmissions exceed the system’s capacity.

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to determine whether:

- Preparations had been made to ensure timely and accurate processing of electronically filed U.S. Return of Partnership Income (Forms 1065) and related Partner's Share of Income, Credits, Deductions, etc. (Schedules K-1), in compliance with the modified requirements of the Taxpayer Relief Act of 1997[1] (TRA).
- The Internal Revenue Service (IRS) would be able to process the numbers of Forms 1065 and related Schedules K-1 projected in the Electronic Tax Administration (ETA) Strategic Plan for Tax Year 2000.

To accomplish our objectives, we did the following:

I. Evaluated electronic partnership filing system computer controls to determine whether they were similar to regular IRS computer controls, including security, backup, separation of duties, and scheduling and run-to-run balancing types of controls.

   A. Conducted a walk-through of electronic filing-related areas, including scheduling, tape library, and computer operations.

   B. Discussed differences between regular return processing and Form 1065 electronic processing with representatives of each of these areas. We focused on determining whether operations controls (scheduling, job setup and recovery, activity logs, balancing, and exception resolution) and security controls were adequate.

   C. Reviewed flowcharts, computer run definitions, and run-to-run balancing equations for Form 1065 electronic processing.

II. Determined whether capacity issues were evaluated to ensure the IRS could effectively process the expected numbers of Forms 1065 and Schedules K-1. This included telecommunications issues such as the number of lines/modems required, system capacity issues necessary for very large numbers of Schedules K-1, and other steps considered to ensure adequate processing capabilities (such as monitoring the system and downloading information as needed).

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[1] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 app.).

A. Discussed these issues with ETA function personnel at the National Headquarters and with processing personnel at the Tennessee Computing Center (TCC). Determined the tools to be used to monitor the workload and identify processing problems.

B. Compared figures used by the ETA function with our estimates of potential electronic filings based on information obtained from the IRS' Business Returns Transaction File (BRTF).[2]

C. Discussed results of voluntary filings to date and any capacity issues that the TCC had identified or considered.

D. Reviewed management information reports related to Form 1065 and Schedule K-1 filing and processing.

E. Reviewed MITRE Corporation Electronic Management System capacity study, for communications issues relevant to the processing of partnership returns.

III. Evaluated controls designed to ensure the accuracy and usability of the Schedules K-1 for the planned matching programs for Fiscal Year 2002.

A. Reviewed the following Tax Year 1999 ETA publications and instructions to taxpayers (and changes to these publications for Tax Year 2000) to determine whether controls will provide for accurate input to the IRS' electronic filing systems:

- *Validation Criteria and Record Layouts for Electronic Filing of Form 1065 U.S. Partnership Return of Income for Tax Year 1999* (Publication 1525).
- *Electronic Filing of Form 1065, U.S. Partnership Return of Income for Tax Year 1999 (Publication 1525 Supplement)* (Publication 3416).
- *Test Package for Electronic Filers of U.S. Partnership Return of Income for Tax Year 1999* (Publication 3225).
- *Procedures and Specifications for Electronic Filing of Form 1065, U.S. Partnership Return of Income For Tax Year 1999* (Publication 1524).

B. Determined whether application controls, such as reasonableness, existence, format, range, and math accuracy, ensured the accuracy of the returns and determined whether checks were in place to ensure agreement between the Forms 1065 and related Schedules K-1.

C. Reviewed the IRS' Requests for Information Services (RIS) to determine whether changes between Tax Years 1999 and 2000 were properly communicated to the Information Technology Services (ITS) function for programming changes.

[2] The BRTF contains information from tax returns filed for the current and 2 previous years.

D. Determined whether funding for matching programs was authorized in final budget figures and whether the IRS has programs in place to compare individual returns with electronic Schedules K-1.

E. Discussed plans for testing matching programs involving Schedules K-1 to ensure usability of information with personnel and management responsible for this program.

F. Reviewed testing of programs by Submission Processing Testing Personnel, including the Systems Acceptability Test plan and test results.

IV. Determined whether business plan objectives were reasonable and projected estimates of returns to be filed were valid based on the requirements of the law and historical filings of Forms 1065 and related Schedules K-1.

A. Determined how the ETA function's estimates of Forms 1065 and related Schedules K-1 to be filed were made and assessed the reliability and accuracy of those estimates.

B. Performed a computer analysis of the BRTF for Tax Years 1998 and 1999 Forms 1065 with 100 or more partners to verify estimates.

C. Researched the IRS' tax records to determine whether IRS data regarding the number of partners in a partnership were reliable.

V. Determined whether controls were in place to identify partnerships having more than 100 partners that do not file electronically and do not have approved waivers from electronic filing requirements.

A. Discussed controls established with Business Masterfile[3] information analysts and ETA function analysts responsible for the electronic filing of Forms 1065.

B. Analyzed the RISs prepared by the analysts and submitted to the ITS function for programming to determine whether requirements of the law were met.

VI. Determined whether controls allowed partnership returns to properly post to the IRS' Business Masterfile.

A. Reviewed a judgmental sample of 30 of the 1,036 partnership returns filed electronically by March 10, 2001. (We selected 30 returns at random from 53 returns provided to us by TCC filed between March 1 and March 10, 2001). We determined whether the information from these returns properly posted to the Business Masterfile.

B. Discussed any exceptions with IRS programmers.

[3] The Masterfile is the IRS' main computer system; it contains taxpayer records.

C. Reviewed a judgmental sample of seven partnership returns posted to the Business Masterfile after programming changes were made to determine whether the changes were effective. (Because we were testing the change to a computer program, the size and universe of the sample were not of concern. If the information posted accurately for one return, it was reasonable to assume it posted accurately for all returns).

VII. Determined whether the ETA function considered the filing patterns of Forms 1065 to allow them to adequately plan for receipt of returns with large numbers of partners.

A. Analyzed Tax Year 1999 Forms 1065 from the BRTF with more than 100 partners to determine when the returns were filed.

B. Analyzed IRS reports of tax return receipts and charted partnership receipts to determine monthly volumes.

C. Estimated the number of Forms 1065, with more than 100 partners, received after April 30, 2000.

Appendix II

Report Distribution List

Commissioner, Large and Mid-Size Business Division LM
Commissioner, Small Business/Self-Employed Division S
Commissioner, Wage and Investment Division W
Deputy Commissioner, Large and Mid-Size Business Division LM
Deputy Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Wage and Investment Division W
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Diversified Electronic Filing, Wage and Investment Division W:E:DEF
Director, Electronic Tax Administration, Wage and Investment Division W:E
Director, Pre-Filing and Technical Guidance, Large and Mid-Size Business Division LM:PFT
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Chief Counsel CC
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M
Audit Liaisons:
    Commissioner, Large and Mid-Size Business Division LM
    Commissioner, Small Business/Self-Employed Division S
    Director, Diversified Electronic Filing, Wage and Investment Division W:E:DEF:RA

Appendix III

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 the Congress.

<u>Type and Value of Outcome Measure</u>:

- Increased Revenue/Revenue Protection – Potential; Information returns (Partner's Share of Income, Credits, Deductions, etc. (Schedules K-1)) for approximately 204,000 partners would not be eliminated from the Internal Revenue Service's (IRS) matching program (see page 3).

<u>Methodology Used to Measure the Reported Benefit</u>:
We projected the 34 percent invalid taxpayer identification number rate for Calendar Year 2000 voluntary electronically filed partnership returns against the approximately 600,000 Schedules K-1 electronically filed as of May 2, 2001. The 34 percent rate was based on the number of returns eliminated because of invalid situations when the IRS made necessary computer runs to refine the Underreporter information returns for the Calendar Year 2000 Underreporter processing program (58,401 of 168,355).