Expanded Information Reporting Should Increase the Proper Reporting of Farm Income, but Additional Steps Could Be Taken

May 28, 2009

Reference Number: 2009-30-068

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 28, 2009

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Expanded Information Reporting Should Increase the Proper Reporting of Farm Income, but Additional Steps Could Be Taken (Audit # 200730IE040)

This report presents the results of our review to determine the extent to which farmers are properly reporting Commodity Credit Corporation (CCC)[1] income payments[2] and whether additional steps may be needed to further enhance compliance with the reporting requirements. The review was part of our risk-based audit coverage under the major management challenge of Tax Compliance Initiatives and includes only individuals who report their farming operations on U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Farming (Schedule F). These individuals typically own unincorporated businesses by themselves and are generally referred to as sole proprietors.

Impact on the Taxpayer

The Internal Revenue Service (IRS) annually receives thousands of information returns reporting CCC income payments that it is unable to use in determining whether the farmers filed tax returns or reported the income reflected on the statements. Because the information returns are unable to be used, opportunities exist for farmers to avoid the scrutiny of the IRS through underreporting income and not filing tax returns. Those farmers who take advantage of such

[1] The CCC is an agency of the United States Department of Agriculture that was created to stabilize, support, and protect farm income and prices. The CCC also helps maintain balanced and adequate supplies of agricultural commodities and aids in their orderly distribution.
[2] CCC income payments include price support payments; conservation program payments; production, emergencies, and compliance payments; and other payments. All are considered taxable income for CCC reporting purposes.

opportunities can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system.

Synopsis

The IRS has taken actions to help alleviate concerns raised by the Government Accountability Office in 1986 and by Senator Charles Grassley in 2003 about the adequacy of the guidance available to assist farmers in properly reporting CCC income payments. One of the most important actions involved expanding the use of information returns. In Tax Year 2008, information returns reporting the taxable income from repaying amounts borrowed with commodity certificates were sent to farmers for the first time. While expanded information reporting should increase the amount of CCC income payments that are properly reported, the IRS could take 2 additional steps that would enhance the effectiveness of the actions already taken and may provide the additional benefit of increasing revenues by an estimated $94 million over 5 years.[3]

The first step involves reducing the number of information returns that the IRS receives from the United States Department of Agriculture (USDA) with inaccurate names and identification numbers. For Tax Years 2003 through 2005, the IRS received 904 information returns reporting $60,000 or more in CCC income payments that it was unable to use in determining whether the farmers filed tax returns and reported the income due to mismatched names and identification numbers. Because the information returns were not used, we estimate some farmers may have avoided paying approximately $318,000 in taxes, interest, and penalties related to unreported CCC income payments.

Second, the IRS should explore strategies to address potentially millions of dollars of improperly reported CCC income payments and suspected cases of underreporting that are not pursued due to resource constraints. While incorporating the recommendations made in this report, the IRS staff could pursue details that we did not because of time and other constraints. For example, we do not know whether improperly reported CCC income payments always affected tax liabilities because some of the income payments may have been mistakenly reported on a different line of the income tax return and were actually taxed. Other details that could be pursued involve evaluating whether the new information returns are having the intended impact on compliance and whether additional taxpayer guidance or enforcement may be needed to better ensure CCC income payments are properly reported.

[3] The additional tax benefit was computed using the average tax, penalty, and interest for the 3 tax years (2003 to 2005) in our sample.

Recommendations

The Director, Examination, Small Business/Self-Employed Division, should coordinate with USDA officials to minimize the number of information returns submitted with mismatched names and identification numbers and initiate actions to develop compliance strategies for ensuring more CCC income payments are properly reported.

Response

IRS management agreed with our recommendations. The coordination with USDA officials falls within the jurisdiction of the Government Entities function, Tax Exempt and Government Entities Division, which has an existing Federal agency compliance program. The Government Entities function will advise the USDA of the law that applies to it as an information return filer and will coordinate with the USDA to improve compliance with information return requirements to minimize the number of returns submitted with mismatched names and identification numbers. The Director, Examination Policy, will take action to determine if there are additional strategies that can be identified and utilized to enhance the compliance of CCC income payments. However, IRS management stated that they believed the outcome measures in the report may be overstated because our analysis did not consider the factors discussed in the following Office of Audit Comment section. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment

We maintain that the outcome measures in the report are reasonable. Because our outcome measures are based on samples of farmers with $60,000 or more in earnings, the amounts would likely be much higher if we had reviewed and projected to the entire population of farmers receiving CCC income payments in Tax Years 2003 through 2005. Our responses to each point mentioned in the IRS response are shown following each IRS comment.

- IRS management asserted that because our review used transcribed data, rather than data from the filed returns, the information from line 7a of Schedule F was not considered because it is not transcribed, which could have decreased the outcome measure. However, having the filed return would not have reduced our outcome measure because, according to the instructions for Schedule F, the taxpayer should include the forfeited amount of the CCC loan on line 7b of the schedule even if they claimed the loan as income. Line 7b is transcribed and had no entries for our exception cases.
- IRS management stated that because our review was limited to 1 year of data per taxpayer, we may not have considered whether the taxpayer reported the forfeited loan as income in a different year. However, because taxpayers are required to report the

taxable amount of CCC loan forfeitures on line 7c, there would be no taxable income on line 7c if the farmer claimed the loan as income in a prior period and we did not take exception to such cases.

- IRS management noted the information return form used to report taxable income from repaying CCC loans [Certain Government Payments (Form 1099-G)] was revised in 2008 to include the reporting of market gains, which may result in improved compliance. However, our outcome measures did not include market gains because the USDA was not required to report market gain income for CCC loans repaid using commodity certificates during the time period we reviewed.
- IRS management suggested that the ongoing global financial crisis may have an impact on commodity prices, which would have an impact on the gains reported on CCC loans. Of course, we have no way to predict future market conditions. However, if future commodity prices are lower than current levels due to global financial problems, farmers could report more taxable income if repayments are made using commodity certificates and future commodity prices are lower than the original loan amounts.
- IRS management asserted that the taxpayers we found with mismatched Taxpayer Identification Numbers may have filed using a different number or been involved in another compliance action as part of the IRS' nonfiler program. However, in our audit work, we searched IRS records to identify the correct taxpayer and matched them to the amount reported by the USDA. Our outcome measure reflects only those taxpayers we could identify, who had filed a return, and who had not reported the amount on the information return. If we had made a projection to the hundreds of taxpayers we could not identify, our results would likely have been much greater.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.

Table of Contents

Abbreviations

AUR	Automated Underreporter
CCC	Commodity Credit Corporation
IRS	Internal Revenue Service
TY	Tax Year
USDA	United States Department of Agriculture

Background

A common source of financing for and payments to farmers are proceeds from the Commodity Credit Corporation (CCC)[1] loan program. Even though bona fide loan proceeds are generally not considered taxable income to borrowers, the billions of dollars borrowed under the CCC loan program can be an exception. Moreover, depending on how loan proceeds are treated, there are different tax consequences that can create challenges for both farmers and the Internal Revenue Service (IRS) in determining the proper amount of income that should be reported and taxed from CCC loan transactions.

Under the CCC loan program, farmers can pledge some or all of their production to secure loans and can make a special election to immediately recognize the loan proceeds as taxable income. Once made, the election generally applies to all tax years and requires farmers to subsequently report as income the excess sales price over amounts previously reported as income when the commodities are sold. Farmers can also use commodity certificates[2] or cash to repay the amounts borrowed. In these instances, the repayment amount can be based on a commodity's prevailing world market price that is lower than the original loan amount, in which case the farmer is required to report the difference as taxable income.

In addition to CCC loan proceeds, farmers received billions of dollars of CCC income payments[3] in Tax Years (TY) 2003 through 2005. To detect and address those who may be underreporting their CCC income payments, the IRS primarily relies on its Examination and Automated Underreporter (AUR) programs.[4] In contrast to the more labor-intensive face-to-face Examination program, the AUR program is generally less intrusive, more automated, and more focused on the underreporting of income. The AUR program also enables the IRS to reach more taxpayers at a lower cost. As shown in Figure 1, the IRS contacted thousands of farmers in TYs 2003 through 2005 and, by far, the majority of the contacts were through the AUR program.

---

[1] The CCC is an agency of the United States Department of Agriculture (USDA) that was created to stabilize, support, and protect farm income and prices. The CCC also helps maintain balanced and adequate supplies of agricultural commodities and aids in their orderly distribution.
[2] Commodity certificates are negotiable financial instruments that farmers can purchase from and exchange with the USDA for outstanding loan collateral rather than forfeit the loan collateral at loan maturity. They were introduced in October 1999 when the Congress amended the 1996 Farm Bill to include provisions for the issuance of commodity certificates. Among other things, the certificates are designed to minimize loan forfeitures and allow commodities to be marketed more freely and competitively.
[3] CCC income payments include price support payments; conservation program payments; production, emergencies, and compliance payments; and other payments. All are considered taxable income for CCC reporting purposes.
[4] The Examination program usually requires an intensive review of a taxpayer's books and records. The AUR program is an automated analysis and processing of potential underreported and/or overreported issues identified through information return matching.

Figure 1: Sole Proprietor Farmers With CCC Income Payments[5] Who Were Contacted by the IRS in TYs 2003 Through 2005

Sole Proprietor Farmers	2003	2004	2005
Number of tax returns filed[6]	1,995,392	1,980,906	1,975,737
Number with CCC income payments	830,178	682,598	729,721
Number examined with CCC income payments	4,372	2,442	3,488
Number contacted by AUR with CCC income payments	34,337	25,176	35,084

Source: Treasury Inspector General for Tax Administration analysis of IRS data.

This review was performed in the IRS Small Business/Self-Employed Division Headquarters in New Carrollton, Maryland, during the period October 2007 through December 2008. Except for auditing IRS databases to validate the accuracy and reliability of the information and evaluating the adequacy of IRS internal controls over information returns,[7] this audit was conducted 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[5] We limited our review in Figure 1 to income payments reported by the USDA to the IRS using Certain Government Payments (Form 1099-G).
[6] Returns filed for sole proprietor farmers were identified by determining the total number of returns filed containing a U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Farming (Schedule F).
[7] We did not validate the IRS' Information Return database because only one information document filer was included in the audit. The accuracy of the data was verified to individual recipients during our case review.

Results of Review

The IRS has taken actions to help alleviate concerns about the adequacy of guidance available to assist farmers and their tax advisors in properly reporting CCC income payments. One of the most important actions involved expanding the use of information returns. While expanded information reporting should increase the amount of CCC income payments that are properly reported, two additional actions need to be taken. First, the number of information returns reporting CCC income payments with inaccurate names and identification numbers needs to be reduced. Second, compliance strategies need to be explored to address potentially millions of dollars of improperly reported income from CCC loan forfeitures and suspected cases of underreporting that are not pursued due to resource constraints.

While incorporating the recommendations made in this report, the IRS staff could pursue details that we did not because of time and other constraints. For example, we do not know whether improperly reported CCC income payments always affected tax liabilities because some of the income payments may have been reported on a different line of the income tax return and were actually taxed. Other details that could be pursued involve evaluating whether the new information returns are having the intended impact on compliance and whether additional education or enforcement may be needed to better ensure CCC income payments are properly reported.

Actions Have Been Taken to Help Alleviate Concerns About the Adequacy of Tax Guidance Available to Farmers

To its credit, the IRS has taken important steps to increase the proper reporting of CCC income payments since concerns were raised by the Government Accountability Office in a 1986 report[8] and subsequently by Senator Charles Grassley in 2003. Perhaps the most important recent step involved the decision to expand the use of information returns by reporting taxable income from repaying CCC loans with commodity certificates on Certain Government Payments (Form 1099-G). From a customer service perspective, this was important because it reinforces the written guidance the IRS published in March 2004 instructing farmers about how to report gains when using commodity certificates to repay CCC loans. It also helps clarify the confusion noted in the following excerpt from a letter sent by Senator Grassley to the IRS National Taxpayer Advocate in May 2003:

> *In addition, I also think there is uncertainty as to the filing and reporting requirements surrounding Form 1099-G. We should be helping and not hindering the American*

[8] *Information Returns Should Increase Proper Reporting of Farm Income* (GAO/GGD-86-69, dated July 1986).

taxpayers and their advisors who are struggling to give sound advice and simply file the correct returns. Please direct your staff to start the review and update of Rev. Rul. 87-103 along with the appropriate reporting requirements by the correct [G]overnment agencies, to give full updated compliance directions for all of the [F]ederal farm subsidy payments, including U.S. Department of Agriculture's current commodity certificate program.

From a compliance perspective, the decision to expand the use of Form 1099-G was important because it will better ensure that the millions of dollars in gains farmers realize each year using commodity certificates to repay CCC loans are properly reported. According to records obtained from the United States Department of Agriculture (USDA), 19,465 farmers realized $221.1 million of market gains from using commodity certificates to repay CCC loans in TYs 2003 through 2005. As summarized in Figure 2, we reviewed a statistically valid sample of farmers who realized $60,000 or more of market gains in 1 or more of these tax years and found that $21.1 million in market gains were not properly reported.

Figure 2: Analysis of Farmers Who Realized $60,000 or More of Market Gains by Using Commodity Certificates to Repay CCC Loans in TYs 2003 though 2005

TY	Number of Farmers	Total CCC Loans in the Sample	Total Market Gains Properly Reported	Total Market Gains Not Properly Reported
2003	65	24	$293,567	$1,404,998
2004	125	37	$386,772	$3,118,384
2005	607	199	$1,081,060	$16,614,920
Totals	797	260	$1,761,399	$21,138,302

Source: Treasury Inspector General for Tax Administration analysis of market gain data received from the USDA.

From a broad tax administration perspective, the filing of information returns is central to the success of the nation's voluntary tax system because it allows the IRS to more economically and efficiently detect and pursue noncompliant taxpayers who can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. Because of the benefits involved, we and others support the enhancement and expansion of information reporting as a key strategy to reduce the underreporting of taxes that in part gives rise to the estimated $345 billion tax gap.[9]

[9] The Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.

Many Information Returns Do Not Contain the Correct Name or Identification Number

The IRS annually receives thousands of information returns reporting CCC income payments that it is unable to use in determining whether the farmers filed tax returns or reported the income reflected on the statements. Without a correct name and identification number, the AUR program's computer routines cannot match the income on the information return with the income reported on a tax return. Because the information returns are unable to be used, opportunities exist for farmers to avoid the scrutiny of the IRS through underreporting income and not filing tax returns. Those farmers who take advantage of such opportunities can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. Consequently, the success of the program in detecting underreporting situations involving Form 1099-G is largely dependent upon the accuracy of the names and identification numbers reported on the documents submitted by the USDA.

To assist Federal departments and agencies, as well as State governments and the private sector, in submitting accurate names and identification numbers on information documents, the IRS introduced an Internet-based identification number matching system in 2003. The system can be accessed prior to submitting information documents and can instantly verify up to 25 identification number and name combinations in IRS records. Larger requests can be sent electronically to the IRS and a response received within 1 business day.

Besides the Internet-based identification number matching system, Congress granted the IRS authority under the tax law to require those who submit information documents to begin backup withholding if an incorrect identification number is not timely resolved after the IRS provides notification of the error. However, we did not find any evidence that either the USDA or the IRS were taking advantage of these tools to minimize the number of information returns with mismatched names and identification numbers.

For TYs 2003 through 2005, the IRS received 18,813 Forms 1099-G with mismatched names or identification numbers reporting income payments of $190.8 million from the USDA. Of these, there were 904 information returns for 429 farmers reporting $60,000 or more in CCC income payments that the IRS was unable to use to determine whether the farmers properly reported the income, due to mismatched names and identification numbers. To estimate the number of farmers who may have improperly reported their CCC income payments by using incorrect names or identification numbers, we used IRS automated data systems to manually research a statistically valid sample of 203 information returns reporting CCC income payments with mismatched names and identification numbers reporting $60,000 or more in earnings.

We successfully validated 150 (74 percent) of the 203 statements and matched them to accounts in the IRS' Master File.[10] Our sample results indicate that 22 farmers had not properly reported $2.5 million in income from 31 information documents, although the statements reported they received, on average, about $115,843 in CCC farm payments. When projected to the population of individual taxpayers, our sample results indicate that as of December 1, 2008, 317 farmers may have avoided paying approximately $318,000 in taxes, interest, and penalties related to unreported CCC income payments.[11]

Recommendation

Recommendation 1: The Director, Examination, Small Business/Self-Employed Division, should coordinate with USDA officials to minimize the number of information returns submitted with mismatched names and identification numbers.

> ***Management's Response:*** IRS management agreed with our recommendation. Management stated that this recommendation falls within the jurisdiction of the Government Entities function, Tax Exempt and Government Entities Division, which has an existing Federal agency compliance program. The Government Entities function will advise the USDA of the law that applies to it as an information return filer and will coordinate with the USDA to improve compliance with information return requirements to minimize the number of returns submitted with mismatched names and identification numbers. However, IRS management stated that they believe our outcome measure may be overstated because our analysis did not consider the factor discussed in the following Office of Audit Comment section.
>
> ***Office of Audit Comment:*** We maintain that the outcome measure is reasonable. IRS management asserted that the taxpayers we found with mismatched Taxpayer Identification Numbers may have filed using a different number or been involved in another compliance action as part of the IRS' nonfiler program. However, in our audit work, we searched IRS records to identify the correct taxpayer and matched them to the amount reported by the USDA. Our outcome measure reflects only those taxpayers we could identify, who had filed a return, and who had not reported the amount on the information return. If we had made a projection to the hundreds of taxpayers we could not identify, our results would likely have been much greater.

---

[10] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[11] See Appendix IV for details.

Compliance Strategies Could Be Explored to Address the Challenges Posed by Loan Forfeitures and Resource Constraints

The IRS has a long history of using special projects to identify, evaluate, and address potential areas of noncompliance within various taxpayer segments. With years of experience to draw upon, the IRS staff involved in such special projects is better positioned than us to suggest cost effective approaches to address potentially millions of dollars of improperly reported CCC income payments and the underreporting cases that are not pursued due to resource constraints. Moreover, without further IRS investigation, we do not know whether CCC income payments that are not properly reported always affect tax liabilities. For example, some of the income payments may have been mistakenly reported on a different line of the income tax return and were actually taxed. Consequently, this is an area where the IRS staff is better positioned than us to make such determinations. Other details that could be pursued involve evaluating whether the new information returns are having the intended impact on compliance and whether additional taxpayer guidance or enforcement may be needed to better ensure CCC income payments are properly reported.

CCC income reported from loan forfeitures is not checked because of computer matching problems

As discussed earlier, farmers can pledge crops as collateral for a CCC loan in 1 tax year but sell or forfeit the crops in a subsequent tax year. In these instances, the tax code allows farmers to report CCC loan proceeds as income in the year the loan proceeds are received rather than in the year the crops are sold or forfeited. To make this election, the IRS requires farmers to attach a statement to the tax return filed for the year that the loan was received. The IRS also requires farmers to separately report the amount of nontaxable and taxable CCC loans forfeited on U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Farming (Schedule F).

The IRS received Acquisition or Abandonment of Secured Property (Form 1099-A) for 5,401 farmers for TYs 2003 through 2005 showing that the farmers settled their CCC loan debt by forfeiting crops (i.e., loan collateral) to the USDA valued at $114.5 million. Although each of the forfeitures was a potential taxable event that must be reported on the farmer's tax return, the documents are not used in the AUR program because they are not designed to provide the information needed to determine the year in which the CCC loan proceeds were taxable. In addition, the tax rules allowing farmers to report CCC loan income in either of 2 years present computer matching problems because IRS computer matching routines are designed to match 1 year at a time.

Our analysis indicates that the inability to computer match such information returns may be leaving a large gap between the number of forfeited CCC loans that are taxed and the number that should be taxed. We evaluated a statistically valid sample of 205 out of 435 CCC loan forfeitures[12] from TYs 2003 through 2005 that involved $60,000 or more and found that 144 (70 percent) loan forfeitures that were not properly reported. When projected to the population, our sample results indicate 306 farmers had not properly reported the forfeitures, including 20 who had not filed 1 or more tax returns. Altogether, we estimate that as of December 1, 2008, the 306 farmers may owe as much as $4.3 million in taxes, penalties, and interest related to loan forfeitures.[13]

Some underreporter cases are not pursued due to resource constraints

According to IRS officials, resource constraints hamper their ability to followup on all identified potential underreporter cases. The AUR program receives millions of documents to review each year but can only work a portion of the documents because of staff availability. As a result, IRS officials use screening techniques to analyze the inventory of potential underreporter cases and attempt to select those cases they believe have the highest tax potential.

We did not evaluate the effectiveness of the internal controls the IRS uses to ensure that only cases having the highest tax potential are selected for followup. However, we did evaluate a statistical sample of 385 out of 87,442 information returns reporting $60,000 or more of CCC income payments and found 21 farmers who did not report CCC income payments of $1.4 million and were not pursued for investigation. When projected to the population of information returns used to select our sample, our results indicate that 4,770 farmers were not pursued even though they may have collectively understated the taxes, interest, and penalties they owe by $14.2 million.[14]

Recommendation

Recommendation 2: As resources become available, the Director, Examination, Small Business/Self-Employed Division, should initiate actions to develop compliance strategies for ensuring more CCC income payments are properly reported.

> ***Management's Response:*** IRS management agreed with our recommendation. The Director, Examination Policy, will take action to determine if there are additional strategies that can be identified and utilized to enhance compliance. However, IRS management stated that they believed the outcome measures in the report may be overstated because our analysis did not consider the factors discussed in the following Office of Audit Comment section.
>
> ***Office of Audit Comment:*** We maintain that the outcome measures are reasonable. Because our outcome measures are based on samples of farmers with $60,000 or more in

[12] Information documents were extracted from the Information Return Master File for Forms 1099-A issued by the USDA.
[13] See Appendix IV for details.
[14] See Appendix IV for details.

earnings, the amounts would likely be much higher if we had reviewed and projected to the entire population of farmers receiving CCC income payments in TYs 2003 through 2005. Our responses to each point mentioned in the IRS response that pertains to the outcome measures reported in this section are shown following each IRS comment.

- IRS management asserted that because our review used transcribed data, rather than data from the filed returns, the information from line 7a of Schedule F was not considered because it is not transcribed, which could have decreased the outcome measure. However, having the filed return would not have reduced our outcome measure because, according to the instructions for Schedule F, the taxpayer should include the forfeited amount of the CCC loan on line 7b of the schedule even if they claimed the loan as income. Line 7b is transcribed and had no entries for our exception cases.
- IRS management stated that because our review was limited to 1 year of data per taxpayer, we may not have considered whether the taxpayer reported the forfeited loan as income in a different year. However, because taxpayers are required to report the taxable amount of CCC loan forfeitures on line 7c, there would be no taxable income on line 7c if the farmer claimed the loan as income in a prior period and we did not take exception to such cases.
- IRS management noted the information return form used to report taxable income from repaying CCC loans (Form 1099-G) was revised in 2008 to include the reporting of market gains, which may result in improved compliance. However, our outcome measures did not include market gains because the USDA was not required to report market gain income for CCC loans repaid using commodity certificates during the time period we reviewed.
- IRS management suggested that the ongoing global financial crisis may have an impact on commodity prices, which would have an impact on the gains reported on CCC loans. Of course, we have no way to predict future market conditions. However, if future commodity prices are lower than current levels due to global financial problems, farmers could report more taxable income if repayments are made using commodity certificates and future commodity prices are lower than the original loan amounts.

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine the extent to which farmers are properly reporting CCC income payments and whether additional steps may be needed to further enhance compliance with the reporting requirements. During the review, we relied on databases provided to us by the IRS. We did not conduct audit tests to determine the accuracy and reliability of the information in any of the databases. However, we did assess the reasonableness of the data as described below and concluded the data were reliable and adequate to conduct our work. Also, we did not evaluate the adequacy of IRS internal controls over information returns because that was outside the scope of the review. To accomplish our objectives, we:

I. Reviewed a significant amount of material to gain an understanding of the tax laws applicable to information returns and the need for enhancing compliance with CCC loan reporting requirements. These sources included the Internal Revenue Code;[1] the United States Treasury Regulations; Government Accountability Office Reports; and the Internal Revenue Manual, job aids, memoranda, Audit Technique Guides, and training materials.

II. Reviewed IRS guidelines and interviewed its personnel to learn how information returns reporting CCC income payments are processed, validated, and perfected.

III. Analyzed extracts[2] from the IRS records of information returns reporting CCC income payments for TYs 2003 through 2005 to identify filing trends and characteristics.

IV. Tested the reasonableness of the information from our extracts of IRS records by comparing it to selected data on the information returns submitted by the USDA.

V. Analyzed a statistically valid attribute sample of 203 of the 429 farmers with information returns reporting CCC income payments in the IRS' records of mismatched names and identification numbers to determine if the mismatches could be resolved and used to identify underreporting and/or nonfiling situations. These information returns were submitted in TYs 2003 through 2005 and reported $60,000 or more in earnings.[3] The sample was based on a 95 percent confidence level, an estimated error rate of 50 percent, and a precision rate of $\pm$ 5 percent.

---

[1] 26 U.S.C. Section 3406 (2006).

[2] Data extracts were received from the Information Return Master File, which contains third-party information reported to the IRS by banks, businesses and other institutions. The IRS uses this third-party information to verify the taxpayers reported this information on their income tax return.

[3] We selected statements reporting $60,000 or more in earnings because it would enable us to focus our efforts on those with the highest amounts of potentially underreported income.

VI. Analyzed a statistically valid attribute sample of 385 of the 87,442 information returns reporting CCC income payments in the IRS' records with accurate names and identification numbers to determine if the information returns could be used to identify underreporting and/or nonfiling situations. These information returns were submitted in TYs 2003 through 2005 and reported $60,000 or more in earnings.[4] The sample was based on a 95 percent confidence level, an estimated error rate of 50 percent, and a precision rate of ± 5 percent.

VII. Analyzed a statistically valid attribute sample of 205 of the 435 Forms 1099-A submitted in TYs 2003 through 2005 and reporting $60,000 or more in earnings[5] to determine the potential amount of underreported income. The sample was based on a 95 percent confidence level, an estimated error rate of 50 percent, and a precision rate of ± 5 percent.

VIII. Used variable sampling techniques based on the underreporting and nonfiling occurrence rates to estimate the dollar amount of earnings for the population of mismatched and accurate information returns reporting CCC loan income that may have been underreported because the taxpayers either did not properly report the income on the tax filed or did not file their tax returns.

IX. Confirmed the accuracy and validity of our projections with statisticians from the IRS Statistics of Income Division.

[4] We selected statements reporting $60,000 or more in earnings because it would enable us to focus our efforts on those with the highest amounts of unreported income.
[5] We selected statements reporting $60,000 or more in earnings because it would enable us to focus our efforts on those with the highest amounts of unreported income.

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Robert Jenness, Audit Manager
Stanley Pinkston, Lead Auditor
Donna Saranchak, Senior Auditor
William Tran, Senior Auditor
Debra Mason, Auditor
Ali Vaezazizi, Auditor

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Examination, Small Business/Self-Employed Division SE:S:E
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

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:

Increased Revenue – Potential; on average,[1] $318,000 per year; $1.6 million over 5 years.[2] This represents the additional revenue associated with taxes, interest, and penalties on assessments by reducing the number of Certain Government Payments (Form 1099-G)[3] with mismatched names and identification numbers reporting $60,000 or more in earnings.[4] The value of the outcome measure does not include amounts (costs) that could partially offset this benefit due to reallocating some resources from other IRS investigations (see page 5).

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with researching, resolving, and investigating Forms 1099-G with mismatched names and identification numbers, we:

1. Analyzed a statistically valid sample of 203 Forms 1099-G with mismatched names and identification numbers reporting $60,000 or more in earnings, to determine the number of documents that could be manually perfected and identified without income tax returns. Our sample was selected from a population of 429 farmers meeting our criteria for whom information returns were submitted for TYs 2003 through 2005.

2. Used the results of our sample to project that mismatched documents which are perfected may result in approximately $318,000 in taxes, penalties, and interest for Forms 1099-G associated with income tax returns filed and not reporting the income.

3. Shared our methodology for projecting our attribute sample into the population of Forms 1099-G with the IRS Statistics of Income Division staff, who confirmed the accuracy and validity of the projections.

---

[1] The 1-year and 5-year projections were computed using the average tax, penalty, and interest per year from our sample period (TYs 2003 to 2005).
[2] The outcome measure for the mismatched sample is computed using the individual results because the information document amounts could not definitively be traced back to the business tax returns.
[3] Forms 1099-G were used for finding number 1 and finding number 3. These samples are mutually independent of each other.
[4] We selected statements reporting $60,000 or more in earnings because it would enable us to focus our efforts on those with the highest amounts of unreported income.

4. Followed the IRS Substitute for Return program procedures[5] for preparing proposed assessments in situations where we could not verify that a tax return was filed. Our calculations of taxes, interest, and penalties were based on these procedures, along with our assumptions that 1) there were no expenses associated with the Forms 1099-G, 2) the individual's filing status was Single, and 3) there were no other sources of income for the taxpayer.
5. Applied and calculated the applicable Federal income tax rates to the 22 Individual Master File taxpayers perfected with mismatched Forms 1099-G.
6. Applied the penalty for failure to file and interest from the due dates of the returns to December 1, 2008, in situations where we could not verify that a tax return was filed.
7. Used the IRS' internal computer programs to apply the interest from the due dates of the returns to December 1, 2008, in situations where returns were filed but we could not verify that the income was reported.

Type and Value of Outcome Measure:

Increased Revenue – Potential; on average, $4.3 million per year; $21.3 million over 5 years. This represents the additional revenue associated with taxes, interest, and penalties on assessments from matching Acquisition or Abandonment of Secured Property (Form 1099-A) containing $60,000 or more in earnings to the tax returns of farmers. The value of the outcome measure does not include amounts (costs) that could partially offset this benefit due to reallocating some resources from other IRS investigations (see page 7).

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with matching Forms 1099-A to the tax returns filed by farmers, we:

1. Analyzed a statistically valid sample of 205 Forms 1099-A reporting $60,000 or more in earnings to determine the potential amount of underreported income. Our sample was selected from a population of 435 Forms 1099-A submitted for TYs 2003 through 2005.
2. Used the results of our sample to project that the income from 306 Forms 1099-A could not be associated with income tax returns filed reporting the income.
3. Shared our methodology for projecting our attribute sample into the population of Forms 1099-A with the IRS Statistics of Income Division staff, who confirmed the accuracy and validity of the projections.

---

[5] The IRS prepares a substitute for return when a taxpayer appears to have a filing requirement but does not comply by voluntarily filing a tax return.

4. Followed the IRS Substitute for Return program procedures for preparing proposed assessments in situations where we could not verify that a tax return was filed. Our calculations of taxes, interest, and penalties were based on these procedures, along with our assumptions that 1) there were no expenses associated with the Forms 1099-A, 2) the individual's filing status was Single, and 3) there were no other sources of income for the taxpayer.
5. Applied and calculated the applicable Federal income tax rates to the 144 farmers where the total Form 1099-A amount could not be fully identified.
6. Used the IRS' internal computer programs to apply the penalty for failure to file and interest from the due dates of the returns to December 1, 2008, in situations where we could not verify that a tax return was filed.
7. Used the IRS' internal computer programs to apply the interest from the due dates of the returns to December 1, 2008, in situations where returns were filed but we could not verify that the income was reported.

Type and Value of Outcome Measure:

Increased Revenue – Potential; on average, $14.2 million per year; $70.9 million over 5 years. This represents the additional revenue associated with taxes, interest, and penalties on assessments from expanding the matching of Forms 1099-G containing $60,000 or more of income to the tax returns filed by farmers. The value of the outcome measure does not include amounts (costs) that could partially offset this benefit due to reallocating some resources from other IRS investigations (see page 7).

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with researching, resolving, and investigating Forms 1099-G to determine if CCC income payments were properly reported, we:

1. Analyzed a statistically valid sample of 385 Forms 1099-G with $60,000 or more of income to determine the potential amount of underreported income. Our sample was selected from a population of 87,442 individual farmers with Forms 1099-G submitted for TYs 2003 through 2005 meeting our income level threshold.
2. Used the results of our sample to project that 4,770 taxpayers meeting our selection criteria for Forms 1099-G could not be associated with income tax returns filed that properly reported the income.
3. Shared our methodology for projecting our attribute sample into the population of Forms 1099-G with the IRS Statistics of Income Division staff, who confirmed the accuracy and validity of the projections.

4. Followed the IRS Substitute for Return program procedures for preparing proposed assessments in situations where we could not verify that a tax return was filed. Our calculations of taxes, interest, and penalties were based on these procedures, along with our assumptions that 1) there were no expenses associated with the Forms 1099-G, 2) the individual's filing status was Single, and 3) there were no other sources of income for the taxpayer.
5. Applied and calculated the applicable Federal income tax rates to the 21 farmers where the total Form 1099-G amount could not be fully identified.
6. Applied the penalty for failure to file and interest from the due dates of the returns to December 1, 2008, in situations where we could not verify that a tax return was filed.
7. Used the IRS' internal computer programs to apply the interest from the due dates of the returns to December 1, 2008, in situations where returns were filed but we could not verify that the income was reported.

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
APR 20 2009

April 20, 2009

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Expanded Information Reporting Should Increase the Proper Reporting of Farm Income, but Additional Steps Could Be Taken (Audit #200730IE040)

Thank you for the opportunity to review the draft report titled "*Expanded Information Reporting Should Increase the Proper Reporting of Farm Income, but Additional Steps Could Be Taken.*" We appreciate your acknowledgement of the improvements that we have made to increase the proper reporting of Commodity Credit Corporation (CCC) income payments, and agree that there are opportunities for further enhancement.

As mentioned in the report, the proper reporting of CCC income can be complex because the recipient may not have been correctly identified, or the proceeds may have been reported in a different year. The recent change to the 1099-G will improve future reporting and facilitate compliance. As resources become available, we will take action to determine if there are additional strategies that can be identified and utilized to enhance compliance.

The report recommends the IRS coordinate with United States Department of Agriculture (USDA) officials to minimize the number of information returns submitted with mismatched names and identification numbers. We agree to coordinate with the USDA to improve compliance with 1099 requirements to minimize the number of information returns submitted with mismatched names and identification numbers.

While we agree with the report's overall conclusions, we believe it may overstate the outcome measures. We believe the increased revenue potential outlined in Appendix IV of your report may be overstated since the analysis did not take into consideration certain key factors. For example:

- The review relied upon transcribed data versus filed tax return data. We believe the use of filed tax return data could have decreased the outcome measures since line 7(a) on Schedule F is not a transcribed field and includes critical information regarding the treatment of forfeited CCC loans.

- The review was limited to one year of data per taxpayer. However, a taxpayer may make an IRC section 77 election to report a forfeited loan in one of two tax years.
- The Form 1099-G was revised, as required, by a 2008 tax law change to include the reporting of market gains. We believe the addition of this field on Form 1099-G will result in improved reporting compliance. By not factoring this in the analysis, the outcome measures may be overstated.
- The linear projection underlying the outcome measures does not reflect any adjustment or consideration of the ongoing global financial crisis that has had a substantial impact on gains on commodity loans to the farmers.
- The IRS has an existing program that pursues non-filed returns based on significant income reported on information returns. The review reflects 21 taxpayers with mismatched Taxpayer Identification Numbers (TINs). These taxpayers may have filed using their correct TIN or may have had additional compliance action as part of our non-filer program.

Attached is a detailed response outlining our corrective actions. If you have questions, you may call me at (202) 622-0600 or Monica Baker, Director, Examination at (202) 283-2659.

Attachment

Attachment

RECOMMENDATION 1:
The Director, Examination, Small Business/Self-Employed Division, should coordinate with USDA officials to minimize the number of information returns submitted with mismatched names and identification numbers.

CORRECTIVE ACTIONS:
This recommendation falls within the jurisdiction of the Government Entities (Tax Exempt and Government Entities Division) which has an existing federal agency compliance program.

Government Entities will advise USDA of the law that applies to it as a Form 1099 payer and will coordinate with the USDA to improve compliance with 1099 requirements to minimize the number of information returns submitted with mismatched names and identification numbers.

IMPLEMENTATION DATE:
February 15, 2010

RESPONSIBLE OFFICIAL:
Director, Government Entities, TEGE Division

CORRECTIVE ACTION(S) MONITORING PLAN:
The Director, Federal, State, and Local Governments will monitor the status and notify the Director, Government Entities (TEGE) of any delays in implementation.

RECOMMENDATION 2:
As resources become available, the Director, Examination, Small Business/Self-Employed Division, should initiate actions to develop compliance strategies for ensuring more CCC income payments are properly reported.

CORRECTIVE ACTION:
The Director, Examination Policy will take action to determine if there are additional strategies that can be identified and utilized to enhance compliance.

IMPLEMENTATION DATE:
March 15, 2011

RESPONSIBLE OFFICIAL(S):
Director, Examination Policy SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:
The Director, Examination Policy will monitor the status and advise the Director, Examination SB/SE of any delays in implementation.