

GAO

Report to the Ranking Minority
Member, Committee on Small Business
& Entrepreneurship, U.S. Senate

January 2002

TAX ABATEMENTS

Better IRS Data Could Benefit Small Businesses and IRS



G A O

Accountability * Integrity * Reliability

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Abbreviations

IRS	Internal Revenue Service
SB/SE	Small Business and Self-Employed



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United States General Accounting Office
Washington, DC 20548

January 31, 2002

The Honorable Christopher S. Bond
Ranking Minority Member
Committee on Small Business and Entrepreneurship
United States Senate

Dear Senator Bond:

The Internal Revenue Service (IRS) abates hundreds of thousands of small business tax assessments annually because either the business or IRS made an error in calculating the taxes.¹ As we stated in our March 2001 report, making and then abating tax assessments imposes costs on taxpayers and IRS.² Preventing the errors that lead to the assessments would stop the need for such abatements and reduce costs in time and money for taxpayers and IRS.

Because of your interest in reducing these costs to taxpayers and IRS, you asked us to determine (1) what IRS' views are on the benefits and costs of collecting data on the errors related to small business tax assessments that have to be abated; (2) what data IRS has on the volume, nature (what tax issue was in error, who made the error, how did the error occur, and why did the error occur) and burden of various tax abatements for small businesses; and (3) what improvements, if any, IRS can make to its data on tax abatements for small businesses and what the related costs are in making them.

To answer these questions, we analyzed IRS' data on tax abatements for small businesses, extracted from IRS master files over a 2-½ -year period ending July 28, 2001. We also discussed with IRS officials any studies or

¹A tax abatement is a reduction of a tax assessment on a taxpayer's account. Not all abatements arise from errors with tax assessments. For example, a taxpayer can carry back a net operating loss to an earlier tax year to abate a correct tax assessment. Because we focused on abatements of assessments associated with an error in determining the amount of tax assessed, we excluded tax abatements due to net operating loss carrybacks, substitute returns that IRS prepares using income information from third parties, and debt discharges, such as for bankruptcy, that are used to offset correct assessments.

²*Tax Administration: IRS Can Help Taxpayers Reduce the Need for Tax Abatements* (GAO-01-328, Mar. 30, 2001).

research IRS had on tax abatements relating to small businesses and the benefits and costs of various steps to use and improve data on tax assessments and the abatement process. We conducted our work from May through December 2001 in accordance with generally accepted government auditing standards.

On December 19, 2001, we provided a detailed briefing to your office on the results of this work. This report includes published briefing slides and transmits our recommendations to the Commissioner of Internal Revenue.³

Results

IRS' Small Business and Self-Employed Division (SB/SE) officials said that to the extent that the volume of tax abatements was significant, having abatement data could be beneficial in providing services to small businesses. The officials said such data might help them find ways to prevent errors that result in abated tax assessments. However, the officials were not sure how much data they needed because they must first weigh the benefits against the costs of collecting, maintaining, and using the data. These benefits and costs depend on such variables as whether data are collected electronically or manually and to what extent the data will be useful in preventing errors.

IRS has some data on tax abatements for small businesses. IRS' master files contain information on taxpayers' accounts, including abatements. In addition, IRS has paper documents on each abatement transaction. In 1999, IRS developed a data file on all abatements that it extracts and updates from the master files quarterly.⁴

We found various problems with IRS' electronic abatement data:

- **Volume of Tax Abatements for Small Businesses**—IRS cannot readily identify small business taxpayers from all other taxpayers because the abatement data file includes all types of taxpayers that fall under SB/SE. These include individual taxpayers who have no wage income, but have rent, royalty, partnership, or pension income. (See app. I, pp. 16 and 17.)

³See app. I for the briefing handout.

⁴IRS developed the data file for our report entitled *Tax Administration: IRS' Abatement of Assessments in Fiscal Years 1995-1998* (GAO/GGD-99-77, June 4, 1999).

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- **Nature of Errors Related to Tax Abatements**—IRS master files have limited electronic data on what tax issue was associated with the error but no electronic data on who caused the error or how the error occurred. However, these data can usually be identified by manually reviewing paper documents for each tax assessment. Data on why the error occurred are harder to find or not documented. (See app. I, p. 18.)
 - **Data on Taxpayer Burden and IRS Costs**—IRS does not capture data on taxpayer burden or on IRS costs associated with assessing and then abating taxes on small business. The abatement process can be time-consuming and burdensome to the taxpayer and costly to IRS. (See app. I, p. 19.)
 - **Use of Available Data on Tax Abatements**—SB/SE officials did not know that the abatement data file existed. Although IRS Information Services analysts updated the abatement data file quarterly, the file was not distributed to anyone. (See app. I, p. 20.)

We identified several steps that IRS could take to improve existing data on tax abatements for small businesses and to obtain additional data on the volume, nature, and burden of tax abatements for small businesses. However, each step imposes some level of costs that IRS needs to weigh against the potential benefits. (See app. I, p. 23.) If IRS begins obtaining data step-by-step, insights into the potential benefits of improving and/or collecting additional data can be gained so more informed judgments can be reached concerning how much data to gather and how to minimize the costs of obtaining it. Even with improved electronic data, IRS may still need to manually review paper abatement documents to determine potential ways to prevent errors.

Recommendations for Executive Action

To improve IRS' ability to understand and address tax abatements for small businesses, we recommend that the Commissioner of Internal Revenue:

- Evaluate the benefits and costs of various steps for improving existing data or collecting additional data on the volume, nature, and burden of small business tax abatements, and
- Use any improved or additional data to study cost-effective ways to reduce or eliminate the errors in tax assessments that have to be abated.

Agency Comments

In a letter dated January 29, 2002, from the IRS Commissioner, he stated that our audit provided valuable insights into steps IRS can take to assist

small businesses. The Commissioner agreed with our first recommendation to evaluate the benefits and costs of various steps for improving existing data or collecting additional data on the volume, nature, and burden of small business tax abatements. The Commissioner said that the implementation of our second recommendation to use any improved or additional data to study cost-effective ways to reduce or eliminate the errors in tax assessments that have to be abated was dependent upon the outcome of IRS' findings based on our first recommendation. The Commissioner's view is consistent with our second recommendation. In addition, the Commissioner said that IRS has already taken some action to implement our recommendations. (See app. II.)

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issuance. We will then send copies of this report to the Chairman of the Senate Committee on Small Business and Entrepreneurship and the Chairman and ranking Minority Member of the House Committee on Small Business. We will also send copies to the Secretary of the Treasury; the Commissioner of Internal Revenue Service; the Director, Office of Management and Budget; and other interested parties. We will make copies available to others on request. The report is also available on GAO's home page at <http://www.gao.gov>.

This report was prepared under the direction of Tom Short. Other major contributors were Thomas Bloom, Larry Dandridge, Marshall Hamlett, and Thomas Venezia. If you have any questions about this report, please contact Tom Short or me on (202) 512-9110.

Sincerely yours,



Michael Brostek
Director, Tax Issues

Appendix I: Briefing to the Staff of the Senate Committee on Small Business and Entrepreneurship



Briefing to the Staff of the Senate Committee on Small Business and Entrepreneurship December 19, 2001

Better Data on Small Business Tax Abatements May Enable IRS to Reduce Taxpayer Burden and IRS Costs



Contents

- Objectives, Scope, and Methodology
 - Background
 - Using Data on Tax Abatements Could Be Beneficial, but Costs Must Be Considered
 - IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems
 - Steps to Improve Data on Small Business Tax Abatements
 - Conclusions
 - Recommendations
-



Objectives, Scope, and Methodology

Objectives:

- What are IRS' views of the benefits and costs of collecting data on the errors related to small business tax assessments that have to be abated?
 - What data does IRS have on the volume, nature (what tax issue was in error, who made the error, how did the error occur, and why did the error occur), and burden of various tax abatements for small businesses?
 - What improvements, if any, can IRS make to its data on tax abatements for small businesses and what are the related costs?
-



Objectives, Scope, and Methodology, continued

Scope and Methodology:

- Analyzed IRS data on tax abatements for small businesses, as extracted from IRS master files for each quarter over a 2-½-year period ending July 28, 2001.
- Discussed with IRS officials any studies or research IRS had on tax abatements relating to small businesses.
- To determine IRS' views of the benefits and costs of collecting data on the errors related to tax assessments that have to be abated, we
 - interviewed IRS officials about the benefits and costs of collecting data on tax abatements.



Objectives, Scope, and Methodology, continued

Scope and Methodology (continued):

- To determine what data IRS has on the volume, nature, and burden of various tax abatements for small businesses, we
 - discussed the types of available data on tax abatements with IRS officials;
 - reviewed a nonstatistical sample of small business tax abatements for self-employed individual filers (Schedule C), small corporate income tax filers (Form 1120), and employment tax filers (Form 941);
 - reviewed a statistical sample of Schedule C abatements that were selected for our prior report--Tax Administration: IRS Can Help Taxpayers Reduce the Need for Tax Abatements (GAO-01-328, March 2001); and
 - reviewed IRS manuals on electronic data files that had abatement data.



Objectives, Scope, and Methodology, continued

Scope and Methodology (continued):

- To determine what improvements, if any, IRS could make to its data on tax abatements for small businesses, we
 - discussed the use and quality of available data on tax abatements with IRS officials;
 - identified tax abatement data that were captured on IRS master files but were not extracted quarterly; and
 - obtained IRS comments on steps that IRS could take to use and improve existing data and to obtain additional data on the volume, nature, and burden of tax abatements for small businesses.
- Conducted our review in accordance with generally accepted government auditing standards from May through December 2001.



Background

- A tax abatement is a reduction of a tax assessment on a taxpayer's account.
- Tax abatements can result from actions initiated by either the taxpayer or IRS.
- Tax abatements result in additional taxpayer burden and IRS costs because they require additional handling to correct the error in a tax assessment.
- Errors in tax assessments can be caused by the taxpayer or IRS. Our prior abatement report on individual taxpayers, including self-employed individual filers (Schedule C), showed that taxpayers made most of the errors.



Using Data on Tax Abatements Could Be Beneficial, but Costs Must Be Considered

- IRS established the Small Business and Self-Employed (SB/SE) Division to better serve small businesses and to help them comply with tax law, thus reducing their burden.
- To help meet such ends, SB/SE is establishing new data systems and determining what data it needs.



Using Data on Tax Abatements Could Be Beneficial, but Costs Must Be Considered, cont'd.

- SB/SE officials said that having abatement data could be beneficial in finding ways to provide services to small businesses.
- Preventing the errors that led to tax assessments could prevent the need for tax abatements, reducing costs in time and money for taxpayers and IRS.
- Data on the nature of these errors are key to determining whether tax abatements can be prevented.
- SB/SE officials were not sure how much data they needed because they had to weigh the benefits and costs associated with variables such as
 - whether to collect the data electronically or manually and
 - to what extent the data will be useful in preventing errors.



IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems

- IRS master files contain data on all abatement transactions.
- IRS also has paper documents on each abatement transaction.
- In 1999, IRS developed a data file on all abatements that extracts some data from its master files on a quarterly basis to make abatement data more accessible.



IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems, cont'd.

IRS has some electronic data on the volume of small business tax abatements.

Our analysis of IRS' abatement data file for the 2-½-year period ending July 2001 showed the following for small businesses.^a

Type of tax abatement	Number (in thousands)	Percentage	Amount (in thousands)	Percentage
Income				
Individual (Form 1040 - Schedule C) ^b	635	36	\$1,865,644	10
Corporate (Form 1120)	322	18	5,408,359	30
Employment (Form 940 and Form 941)	680	39	6,778,840	38
Other Taxes	114	7	3,790,502	21
Total	1,751	100	\$17,843,345	100

Note: Percentages may not sum to 100 because of rounding.

^aThe number and amount of tax abatements from August 1999 to July 2000 and August 2000 to July 2001 were about equal.

^b The number and amount of individual income tax abatements includes both business (e.g., rent) and nonbusiness issues (e.g., personal exemptions).



IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems, cont'd.

Problems exist in the electronic data on the volume of tax abatements.

- IRS cannot readily identify small business taxpayers from all other taxpayers because the abatement data file includes all types of taxpayers that fall under SB/SE, including individual taxpayers who have no wage income, but have rent, royalty, partnership, or pension income.
- Tax abatements for self-employed individuals did not always relate to business issues. Some tax abatements related to individual issues, such as exemptions and itemized personal deductions.
- Some employment tax filers were coded as small businesses, even though they were subsidiaries of large corporations. IRS Information Services (IS) officials were aware of this problem.



IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems, cont'd.

- We also found that four data items were not being extracted correctly from the master files because of a programming error. For example, the asset classification code, which is used to categorize businesses based on the value of assets, was shown as "000" for all transactions. IRS IS officials were not aware of this programming error until we brought it to their attention. The officials agreed to start correcting the programming error.
-



IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems, cont'd.

IRS has little electronic data on the nature of errors related to abatements.

- IRS master files have limited electronic data on what tax issue was associated with the error but no electronic data on who caused the error, how the error occurred, or why the error occurred.
- Data on what tax issue, who made the error, and how the error occurred usually can be identified by manually reviewing documents for each tax assessment being abated. Data on why the error occurred are harder to find or not documented.
- Regarding what tax issue was associated with the error, the amount of electronic data varied by type of tax.
 - IRS captures error data under broad codes (e.g., business income or loss) for income tax issues.
 - IRS captures error data for each line item on the Form 941 for employment tax issues, such as taxable social security wages.



IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems, cont'd.

IRS has no data on taxpayer burden or IRS costs for abatements.

- Abating a tax assessment imposes burden on taxpayers. When an error in a tax assessment is identified and corrected by an abatement, small businesses usually have to supply additional data to correct the error. For example, small businesses often have to file amended tax returns or have multiple contacts with IRS. This can be time-consuming and burdensome to the taxpayer.
- IRS does not have data on how often burdens are imposed on small businesses by abating tax assessments.
- These and other steps in the assessment and abatement processes also create costs for IRS. For example, IRS may send out bills or make other attempts to collect the tax assessment that is ultimately abated. IRS does not capture data on such costs.



IRS Has Some Data on Small Business Tax Abatements, but the Data Have Problems, cont'd.

IRS did not utilize available data on small business tax abatements.

- SB/SE officials were not aware that IS extracted the abatement data file from IRS master files on a quarterly basis.
- Although IS analysts updated the abatement data file quarterly, the resulting file was not distributed to anyone.
- When we showed SB/SE officials the file, they said that tax abatements were a significant issue worth reviewing.
- SB/SE officials are designating a team to determine how to utilize available data on tax abatements in order to help identify errors in tax assessments.



Steps to Improve Data on Small Business Tax Abatements

- We identified several steps that IRS could take to improve existing data and to collect additional data on the volume, nature, and burden of tax abatements for small businesses. (See p. 23.)
 - Each step would impose some level of costs to the extent that IRS uses and improves the existing data as well as collects, verifies, and uses additional data. Cost factors to consider include
 - number of staff,
 - training of staff, and
 - computer resources.
 - We could not determine the actual benefits and costs for each step because the data were not readily available.
-



Steps to Improve Data on Small Business Tax Abatements, continued

- If IRS begins obtaining data step-by-step, insights into the potential benefits of improving and/or collecting additional data can be gained so more informed judgments can be reached concerning how much data to gather and how to minimize the costs of obtaining it.
 - Even with improved electronic data, IRS may still need to manually review abatement documents to determine potential ways to prevent errors in tax assessments that need to be abated.
-



Steps to Improve Data on Small Business Tax Abatements, continued

Steps	1	2	3	4
Description	Start using and improving (e.g., clarifying business-related codes) the existing electronic data on the volume of tax abatements.	Expand the collection of existing electronic data, when abating taxes, on what tax issues were related to the abatements.	Collect new electronic data, when abating taxes, on who made the error and how the error was made.	Collect new data on why the error occurred, taxpayer burdens created, and IRS costs incurred.
Potential benefits	Better identify the number and dollar volume of tax abatements for small business tax issues by type of tax and type of small business.	Identify the specific business tax issues associated with the errors in order to focus on the line items associated with a higher volume of the tax abatements.	In conjunction with electronic data on volume and tax issue, knowing who made errors (e.g., IRS, taxpayer, or thirdparty) and how errors were made (e.g., left line blank, entered wrong amount, or entered right amount on wrong line) would provide insights on errors in the tax assessments being abated.	In conjunction with the other electronic data, IRS could uncover the root causes for errors and the related burdens and costs, which could guide IRS to solutions that would help prevent the errors.
Potential costs	Some costs and time will be spent to use and improve the existing abatement data file.	Costs would include those to add codes to the existing data file as well as to enter and ensure the accuracy of the codes.	Types of costs would be similar to step 2. Depending on the costs, IRS might decide to collect such data for a random sample of tax abatements rather than electronically.	Types of costs would be similar to step 2. Because of the costs, IRS might decide to collect the data for a random sample of tax abatements rather than electronically.



Conclusions

- IRS abates hundreds of thousands of small business tax assessments totaling billions of dollars annually because either the business or IRS made an error in calculating the taxes.
 - IRS SB/SE officials acknowledged that such a volume of tax abatements was a significant issue.
 - IRS does not have adequate data on the volume of tax abatements, nature of related errors, and the related burden and costs.
 - If IRS had such data, it would be better positioned to research cost-effective ways to prevent the errors related to tax assessments that are abated.
-



Recommendations

- To improve IRS' ability to understand and address tax abatements for small businesses, we recommend that the Commissioner of Internal Revenue:
 - Evaluate the benefits and costs of various steps for improving existing data or collecting additional data on the volume, nature, and burdens of small business tax abatements, and
 - Use any improved or additional data to study cost-effective ways to reduce or eliminate the errors in tax assessments that have to be abated.
-

Appendix II: Comments From the Internal Revenue Service



COMMISSIONER

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

January 29, 2002

Mr. Michael Brostek
Director, Tax Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Brostek:

I reviewed your draft report titled "Tax Abatements - Better IRS Data Could Benefit Small Businesses and IRS" and believe your audit provided valuable insights into steps we can take to assist small business taxpayers. After reviewing your report and recommendations, we have consulted various areas of the IRS that perform tax adjustments. We have also collected additional data to assist us in determining our course of action.

I agree with the first recommendation, to evaluate the benefits and costs of various steps for improving existing data or collecting additional data on the volume, nature, and burden of small business abatements. I believe implementation of your second recommendation, to use any improved data to study cost-effective ways to reduce or eliminate the errors in tax assessments that have to be abated, depends upon the outcome of our findings based on your first recommendation.

The Commissioner, Small Business/Self-Employed (SB/SE) has established a team to study both your findings and any additional data developed by the IRS on this issue. The team will study various alternatives for compiling more usable data or to improve the data already available. We will also consider the costs associated with these alternatives. The team is tentatively scheduled to hold its initial meeting the week of March 4, 2002.

Your report highlighted an opportunity for improvement. I expect to use that information, along with additional data we gather, to determine the course of action that would best assist our taxpayers while also maintaining fiscal responsibility.

If you have any questions, please contact John Ressler, Director, Customer Account Services, Small Business/Self-Employed Division at (859) 669-5557.

Sincerely,

Handwritten signature of Charles O. Rossotti in cursive script.
Charles O. Rossotti

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