
Volume 59

Issue 2 *The 100th Anniversary of the Revenue
Act of 1913: Marking a Century of Income Tax
Law in the United States*

Article 6

January 2015

The Need for Tax Reform: Schedule K-1 Document Matching Program and Effective Revenue Collection

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Recommended Citation

VALERIYA AVDEEV, *The Need for Tax Reform: Schedule K-1 Document Matching Program and Effective
Revenue Collection*, 59 N.Y.L. SCH. L. REV. (2014-2015).

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The Need for Tax Reform: Schedule K-1 Document Matching Program and Effective Revenue Collection

59 N.Y.L. SCH. L. REV. 345 (2014–2015)

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THE NEED FOR TAX REFORM

I. INTRODUCTION

With the federal code, in addition to its regulations—running approximately 70,000 pages long—our tax code is one of the most complex tax codes that exists today.¹ The Internal Revenue Code (IRC) alone is 16,000 pages.² However, non-compliance has been a major issue, especially in recent years.³ Because of non-conservative tiering strategies employed by so many large companies, Congress has focused its attention on an effort to rewrite the tax code.⁴ The Joint Committee on Taxation recently published a 568-page report on various tax reform options, including a draft on revising subchapters S and K that address flow-through entities (or pass-through entities).⁵ In the end, whatever shape reform may take, it will have to center around effective revenue collection, cost savings, and effective voluntary compliance.

A flow-through entity is a business entity that can generate or receive taxable income, but is not subject to income tax itself. A flow-through entity's gains and losses are allocated to those with ownership interests. The owners then report such gains and losses on their own income tax returns. In recent years, such entities have become both very popular and a growing tax compliance concern.⁶ In particular, pass-through entities are not subject to federal income tax and pass all of their assessed tax liability on to their owners, partners, or shareholders.⁷ The result is a structure with multiple layers of pass-through entities, otherwise known as "tiering."⁸ This structure provides a way for taxpayers to avoid paying tax immediately at the entity level and, possibly, even at the ownership level.⁹ As such, the established Schedule K-1 document matching program is an invaluable instrument that can be used to trace income allocations and combat such non-compliance. However, since its implementation in 2001, the Schedule K-1 document matching program has been ineffective in combating non-compliance, mainly due to manual transcription errors, incorrect taxpayer identification numbers (TINs), and the matching of only a few select lines on Form 1065 Schedule K-1 ("Schedule K-1").

1. Fareed Zakaria *GPS: U.S. Tax System and Politics; Planning for a Year of Planned Change; The World's Banker; The Silicon Valley View* (CNN broadcast Mar. 25, 2012), transcript available at <http://transcripts.cnn.com/TRANSCRIPTS/1203/25/fzgps.01.html>.

2. *Id.*

3. *Id.*

4. Bruce Bartlett, *Getting to Tax Reform*, N.Y. TIMES (May 28, 2013, 12:01 AM), http://economix.blogs.nytimes.com/2013/05/28/getting-to-tax-reform/?_php=true&_type=blogs&r=0.

5. *Id.*; see also Mel Schwarz & Dustin Stamper, *Camp Releases Tax Reform Discussion Draft on Pass-Throughs as Parties Offer Opposing Budget Visions for Tax Policy*, TAX LEGISLATIVE UPDATE (Grant Thornton LLP), Mar. 13, 2013, available at http://www.grantthornton.com/staticfiles/GTCom/Tax/TF_TLU_TPU%20files/TLU_2013-04_Camp_draft_pass-throughs_final.pdf.

6. Julie Buckel, *Flow-Throughs and Tiering: Using Schedule K-1 Data to Study Tax Compliance*, INTERNAL REVENUE SERV. 1 (June 2003), <http://www.irs.gov/pub/irs-soi/buckel.pdf>.

7. *Id.*

8. *Id.*

9. *Id.*

Part II of this article introduces the Schedule K-1 document matching program and discusses its implementation. Part III addresses the reasons behind the program's ineffectiveness. Part IV discusses feasible solutions to combat the ineffectiveness of the Schedule K-1 matching program. Part V is the Conclusion.

II. IMPLEMENTATION OF THE SCHEDULE K-1 DOCUMENT MATCHING PROGRAM

Pursuant to congressional mandate, the Internal Revenue Service (IRS) began implementing its Schedule K-1 document matching program in 2001 for tax year 2000.¹⁰ The Schedule K-1 document matching program was designed to match information reported on Schedule K-1s with the information ultimately filed on owners' individual returns.¹¹ Pass-through entities include partnerships, subchapter S corporations, and trusts that distribute income.¹² Although they are not directly subject to income tax, flow-through entities are required to file information tax returns, which must include distributions made to owners on Schedule K-1s.¹³ As such, the Schedule K-1 document matching program provides a way for the IRS to determine whether owners of flow-through entities are properly reporting all of the income distributed to them on their individual tax returns.¹⁴

In 2000, Congress funded the Staffing Tax Administration for Balance and Equity Initiative to help fund the document matching program;¹⁵ the Schedule K-1 transcription process cost approximately \$20 million.¹⁶ Because of the growing belief that individuals use flow-through entities to execute tax schemes, the Senate Committee on Finance stressed the importance of including pass-through entity information in the matching program.¹⁷ Specifically, the IRS estimated that for tax year 2001, 8.5 million flow-through information returns reported \$850 billion of income.¹⁸ However, the IRS also estimated that between 6% and 15% of taxpayers to whom this income flowed through omitted it from their respective individual tax returns.¹⁹ As such, the IRS estimated that

10. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2003-30-071, THE INTERNAL REVENUE SERVICE COULD REDUCE THE NUMBER OF UNNECESSARY NOTICES SENT TO TAXPAYERS REGARDING UNREPORTED INCOME FROM SCHEDULES K-1 (Mar. 2003) [hereinafter TIGTA, 2003-30-071].

11. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-1040, TAX ADMINISTRATION: IRS SHOULD TAKE STEPS TO IMPROVE THE ACCURACY OF SCHEDULE K-1 DATA 2 n.4 (2004) [hereinafter GAO-04-1040].

12. *Id.* at 1.

13. *Id.*

14. *Id.*

15. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-03-667, TAX ADMINISTRATION: CHANGES TO IRS'S SCHEDULE K-1 DOCUMENT MATCHING PROGRAM BURDENED COMPLIANT TAXPAYERS 6 (2003) [hereinafter GAO-03-667].

16. *Id.*

17. TIGTA, 2003-30-071, *supra* note 10, at 1.

18. *Id.* at 2.

19. *Id.*

THE NEED FOR TAX REFORM

a 1% increase in voluntary compliance would raise an additional \$500 to \$750 million in tax revenue annually.²⁰

But in 2002, 74% of information returns for tax year 2000 were filed on paper.²¹ Therefore, those returns that were not electronically filed (“e-filed”) had to be manually transcribed into IRS computers for use in its Automated Underreporter Program,²² which provides computerized assessment of potential non-compliance issues identified through the document matching program.²³ This process was costly, time-consuming, and unusual.²⁴ After all, Schedule K-1 information had not been manually inputted into the IRS database since 1995.²⁵ The following section discusses the history, implementation, and development of the Schedule K-1 document matching program.

A. Schedule K-1 Matching Process

Since its formation, the Schedule K-1 document matching program was designed to match only two lines to owners’ individual tax returns—interest and dividends, lines 5 and 6 respectively on Schedule K-1²⁶—because the level of risk associated with different types of income varied. For example, prior to the creation of the Schedule K-1 matching program, interest and dividend income lines could easily be identified on Schedule K-1 and, as such, tracing these lines to the owners’ individual returns was not very complex.²⁷ The capital gains and royalties income lines, on the other hand, were more difficult to trace to the owners’ individual returns because the information related to those lines could be combined and reported on other schedules of the owners’ returns.²⁸ Finally, income from trade or business activities, rental real estate, other rental activities, and guaranteed payments were considered high risk because of the difficulty in tracing such income from those items on individual tax returns.²⁹ However, once the Schedule K-1 document matching program was implemented and tested, the IRS discovered that even interest and dividend line information could not be effectively matched and separated from interest and dividend information reported on Form 1099.³⁰

20. *Id.*

21. GAO-03-667, *supra* note 15, at 5. For tax year 2000, 14.3 million Schedule K-1s were filed on paper and only about 5 million were filed electronically. *Id.*

22. *Id.*

23. IRM 4.19.3.1 (Sept. 19, 2014).

24. See TIGTA, 2003-30-071, *supra* note 10, at 1; GAO-03-667, *supra* note 15, at 5.

25. GAO-03-667, *supra* note 15, at 5.

26. *Id.* at 2.

27. *Id.* at 8.

28. *Id.*

29. *Id.*

30. *Id.* at 9. Compare U.S. DEP’T OF THE TREASURY INTERNAL REVENUE SERV., I.R.S. FORM 1065: SCHEDULE K-1: PARTNER’S SHARE OF INCOME, DEDUCTIONS, CREDITS, ETC. (2013), available at <http://www.irs.gov/pub/irs-pdf/f1065sk1.pdf> [hereinafter FORM 1065: SCHEDULE K-1 (2013)], with U.S.

After the first unsuccessful test of the Schedule K-1 matching program, the IRS decided to revamp and expand the program for tax year 2003 to include additional categories of income, including flow-through income or loss from trade or business activities, rental real estate, other rental activities, and guaranteed payments.³¹ Therefore, the Schedule K-1 document matching program was designed to compare information only on a selective basis—specifically, lines 1 through 6 of Schedule K-1.³² Other Schedule K-1 line items (such as royalties, capital gains, collectibles, § 1231 property gains or losses, and other income) were neither included nor compared in the matching program.³³

As part of the IRS's general underreporter matching program, the Schedule K-1 program was established to match third-party data filed with information tax returns against individual tax return data to verify that income was reported as required.³⁴ If discrepancies were found, an underreporter case was generated.³⁵ However, the IRS did not follow up on all of these potential underreporter cases.³⁶ In 2002, for example, only 21% of potential underreporter cases were selected for further review.³⁷ IRS tax examiners performed a manual screening of these returns to identify whether income had been omitted.³⁸

For example, it is common for taxpayers to reduce or net their flow-through income by subtracting carryover losses or expenses against their current-year partnership income, even though tax return instructions provide otherwise.³⁹ If the income was identified or traced on the taxpayer's return, the underreporter case was closed. However, if a reasonable doubt still existed after such manual review, then an underreporter notice was sent to the taxpayer informing him of the proposed change to tax liability.⁴⁰ The taxpayer could agree with the proposed assessment of tax, or request an appeal.⁴¹

DEPT OF THE TREASURY INTERNAL REVENUE SERV., I.R.S. FORM 1099-MISC: MISCELLANEOUS INCOME (2014), available at <http://www.irs.gov/pub/irs-pdf/f1099misc.pdf>.

31. GAO-03-667, *supra* note 15, at 9, 13–14. The numbering of line items on Schedule K-1 refers to the updated post-2004 Schedule K-1. See FORM 1065: SCHEDULE K-1 (2013), *supra* note 30.

32. See GAO-03-667, *supra* note 15, at 9; FORM 1065: SCHEDULE K-1 (2013), *supra* note 30.

33. See GAO-03-667, *supra* note 15, at 9; FORM 1065: SCHEDULE K-1 (2013), *supra* note 30.

34. GAO-03-667, *supra* note 15, at 5.

35. See *id.*

36. *Id.*

37. *Id.* In 2002, out of the potential 14 million underreporter cases identified by the document matching program, the IRS chose to test only 3 million. *Id.*

38. *Id.*

39. *Id.* at 8.

40. *Id.* at 5.

41. *Id.*

THE NEED FOR TAX REFORM

The IRS began sending non-compliance notices to taxpayers in April 2002.⁴² In August of that year, after receiving data that two-thirds of those notices were sent to compliant taxpayers, the IRS stopped sending such notices.⁴³ In those four months, the IRS had sent 69,097 notices to taxpayers.⁴⁴ Some of the taxpayers who received non-compliance notices were compliant, but had incorrectly reported their income and deductions on their individual tax returns.⁴⁵ A non-compliance notice requires several hours to complete; the process includes providing explanations and compiling necessary forms. Thus, completing a non-compliance notice wastes time and resources if a taxpayer is compliant.⁴⁶ Since the Schedule K-1 program had proved ineffective,⁴⁷ the IRS revised its Schedule K-1 matching process to create a more effective system with an eye towards tracing income allocations and combating non-compliance.⁴⁸

III. THE PROGRAM NEEDS IMPROVEMENT

Due to manual transcription errors, incorrect TINs, and the matching of only a few lines on Schedule K-1, the IRS was unable to reach an acceptable audit no-change rate.⁴⁹ Since only 33% of all notices generated through the new Schedule K-1 document matching program could potentially lead to a tax assessment, it was apparent that the program needed substantial improvement.⁵⁰ Consequently, in 2003, the IRS began implementing steps to revise⁵¹ and improve the Schedule K-1 document matching program.⁵² For example, the IRS started issuing non-compliance notices to those taxpayers who omitted Schedule K-1 information from their tax returns completely.⁵³ Moreover, the IRS continued to send notices to those taxpayers who had received a non-compliance letter the previous year and agreed with the assessment.⁵⁴ Furthermore,

42. *Id.* at 9.

43. *Id.* at 10–11.

44. *Id.* The IRS planned to send out 97,200 notices, but actually sent out 69,097. *Id.* at 10, 12.

45. *Id.* at 10.

46. *Id.* at 17.

47. *See id.*

48. *See generally* GAO-03-667, *supra* note 15.

49. *See id.* at 15. *See generally* TIGTA, 2003-30-071, *supra* note 10. A no-change rate is the rate of notices that were resolved in a taxpayer's favor without any extra tax assessment. *See* Michael R. Phillips, *Memorandum for Commissioner, Small Business/Self-Employed Division and Commissioner, Wage and Investment Division*, TREASURY INSPECTOR GEN. FOR TAX ADMIN. 2 (Sept. 25, 2006), in TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2006-30-159, THE SCHEDULE K-1 MATCHING PROGRAM HAS BEEN IMPROVED, BUT MORE CAN BE DONE TO INCREASE ITS EFFECTIVENESS (Sept. 25, 2006), available at <http://www.treasury.gov/tigta/auditreports/2006reports/200630159fr.pdf>.

50. *See* GAO-03-667, *supra* note 15, at 10.

51. *Id.* at 15.

52. *Id.*

53. *Id.*

54. *Id.*

if the taxpayer received a non-compliance notice, but was able to explain the discrepancies, the IRS would not send that taxpayer another notice the following year.⁵⁵ Finally, if a new non-compliant taxpayer was identified, the IRS would send a notice of deficiency to that taxpayer in the current year.⁵⁶

A. Changes Implemented by the IRS to Improve the Matching Program

To improve its Schedule K-1 matching program and reduce the likelihood of sending notices to compliant taxpayers, the IRS decided to educate taxpayers and tax practitioners by issuing elaborate instructions and notices on how to properly report income and deduction items on Schedule K-1.⁵⁷ Moreover, pursuant to the recommendation made in March 2003 by the Treasury Inspector General for Tax Administration (TIGTA), the IRS simplified its Form 1040 Schedule E ("Schedule E").⁵⁸ As such, for the 2003 filing season, the IRS issued a revised Schedule E that alerted taxpayers not to net their income and expenses, and to pay special attention to written instructions.⁵⁹

In addition, to further improve its matching program, an IRS task force studied the possibility of simplifying Schedule K-1 and working with software vendors to increase the number of e-filed information returns.⁶⁰ To date, the IRS has made progress on both of these goals. For example, prior to tax year 2004, Schedule K-1 was two pages in length, non-transparent, and cumbersome.⁶¹ The first page of the form consisted of a partner's capital account analyzed through a series of thirteen lines.⁶² The second page consisted of distributive share items analyzed through a series of twelve lines.⁶³ However, the revised Schedule K-1 was substantially simplified for tax year 2004.⁶⁴ Now, the form consists of only one page, which includes an information section and twenty line items.⁶⁵ The revised Schedule K-1 is easier to read—it is very transparent and resembles other

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.* at 16.

59. *Id.*

60. *Id.*

61. See U.S. DEP'T OF THE TREASURY INTERNAL REVENUE SERV., I.R.S. FORM 1065: SCHEDULE K-1: PARTNER'S SHARE OF INCOME, CREDITS, DEDUCTIONS, ETC. (2002), available at <http://www.irs.gov/pub/irs-prior/f1065sk1--2002.pdf>.

62. *Id.*

63. *Id.*

64. See U.S. DEP'T OF THE TREASURY INTERNAL REVENUE SERV., I.R.S. FORM 1065: SCHEDULE K-1: PARTNER'S SHARE OF INCOME, DEDUCTIONS, CREDITS, ETC. (2004), available at <http://www.irs.gov/pub/irs-prior/f1065sk1--2004.pdf> [hereinafter FORM 1065: SCHEDULE K-1 (2004)]; U.S. DEP'T OF THE TREASURY INTERNAL REVENUE SERV., I.R.S. FORM W-2: WAGE AND TAX STATEMENT (2004), available at <http://www.irs.gov/pub/irs-prior/fw2--2004.pdf>; U.S. DEP'T OF THE TREASURY INTERNAL REVENUE SERV., I.R.S. FORM 1099-MISC: MISCELLANEOUS INCOME (2004), available at <http://www.irs.gov/pub/irs-prior/f1099misc--2004.pdf>.

65. FORM 1065: SCHEDULE K-1 (2004), *supra* note 64.

THE NEED FOR TAX REFORM

information-reporting forms, such as Forms W-2 or 1099.⁶⁶ Moreover, each line of Schedule K-1 now has a code associated with it for ease of reference, which makes completing the form easier.⁶⁷ In addition, the most frequently used income items distributed from a partnership or an S corporation now appear first, which explains the reasoning behind the line items used for the matching program.⁶⁸

The IRS has also made progress on the number of e-filed returns since 2002. For example, as discussed above, only 26% of all information returns for tax year 2000 were e-filed.⁶⁹ In tax year 2005, for example, only 3% of Form 1120S S corporation pass-through entity returns were e-filed⁷⁰—increasing substantially to 63% in tax year 2009.⁷¹

B. Changes Were Unproductive

Even after the changes to the Schedule K-1 document matching program, the program's effectiveness in identifying non-compliance and increasing revenue collection had not improved.⁷² Although the IRS halted the program because it incorrectly sent notices to compliant taxpayers, the program once again focused on the same flow-through income categories, covering distributive items found on lines 1 through 6 of Schedule K-1.⁷³ Specifically, the only matched line-income categories included ordinary business income or loss, rental real estate income or loss, other rental income or loss, interest income, ordinary dividends, qualified dividends, and royalties.⁷⁴ Moreover, the IRS announced to external stakeholders⁷⁵ that, for tax year 2003, the Schedule K-1 matching program would remain the same—namely, testing

66. *IRS Revises Schedule K-1 to Reduce Filing Complexity*, COLO. BAR ASS'N, <http://www.cobar.org/index.cfm/ID/1498/subID/5894/TAX/IRS-Revises-Schedule-K-1-to-Reduce-Filing-Complexity/> (last visited Jan. 25, 2015).

67. *Id.*

68. *Id.* The lines used for the current Schedule K-1 matching program are lines 1 through 6 since those are the most frequently used distributive share items. *See* FORM 1065: SCHEDULE K-1 (2013), *supra* note 30; GAO-03-667, *supra* note 15, at 13.

69. *See* GAO-03-667, *supra* note 15, at 5.

70. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2011-30-048, SUCCESSFULLY PROCESSING LARGE CORPORATE TAX RETURNS ELECTRONICALLY WAS A MAJOR ACCOMPLISHMENT, BUT ELIMINATING MORE COMPLIANT RETURNS FROM THE AUDIT STREAM IS A WORK IN PROGRESS 5 (2011), *available at* <http://www.treasury.gov/tigta/auditreports/2011reports/201130048fr.pdf>. In tax year 2005, 984 Form 1120S returns out of a total of 31,922 Form 1120S returns were e-filed. *Id.*

71. *Id.* In tax year 2009, 26,231 Form 1120S returns out of a total of 41,124 Form 1120S returns were e-filed. *Id.*

72. GAO-03-667, *supra* note 15, at 14.

73. *Id.*

74. *Id.*

75. "External stakeholders," a commonly used term in the tax field, are tax practitioners under Circular 230 who could be affected by changes to the Schedule K-1 document matching program. Practice Before the Internal Revenue Service, 31 C.F.R. § 10.3 (2014). These external stakeholders include attorneys, certified public accountants, enrolled agents, and Big 4 accounting firms that have clients who file pass-

only some lines on Schedule K-1 against owners' individual tax returns.⁷⁶ Therefore, since the program continued to prove ineffective as a result of the IRS's inability to use Schedule K-1 data to detect non-compliance, the Committee on Finance asked the U.S. Government Accountability Office (GAO)⁷⁷ to analyze the issues and produce a report with recommendations.⁷⁸

C. Subsequent Attempts to Reevaluate the Program

The GAO was asked to: (1) assess the accuracy of the Schedule K-1 document matching program and address the issue of manual transcription errors and invalid TINs; (2) address the issue of whether the ineffectiveness of the Schedule K-1 document matching program impaired the IRS's ability to identify non-compliance cases; and (3) determine if an increase in e-filing pass-through tax returns could make the program more effective.⁷⁹

1. Accuracy of Schedule K-1 Data

Since over \$1 trillion in income was distributed by flow-through entities in tax year 2002 alone, the Schedule K-1 document matching program is an extremely valuable revenue-collection tool for the IRS.⁸⁰ Yet, the IRS estimates 6% to 15% of that income is unreported, resulting in a substantial loss in revenue.⁸¹ For tax years 2000 and 2001, through its document matching program, the IRS identified approximately \$4.1 billion in underreported income and "assessed about \$110 million in additional taxes."⁸² However, the assessed additional revenue did not turn into actual revenue collected due to numerous limitations of the Schedule K-1 document matching program.⁸³ According to the GAO, the program inaccurately assesses data due to errors from transcribing paper-filed Schedule K-1s and invalid TINs filed on both paper and e-filed pass-through tax returns.⁸⁴

through returns. *Id.* In other words, if a client is filing a partnership return, the preparer of the return needs to understand the reporting requirements and the likelihood of being audited. *See id.* § 10.3(f).

76. GAO-03-667, *supra* note 15, at 14.

77. The GAO is an independent, nonpartisan agency that investigates and analyzes how the federal government spends taxpayer dollars. *About GAO*, U.S. GOV'T ACCOUNTABILITY OFFICE, <http://www.gao.gov/about/index.html> (last visited Jan. 25, 2015).

78. *See* GAO-04-1040, *supra* note 11.

79. *Id.* at 2.

80. *Id.*

81. *Id.*

82. *Id.* at 7.

83. *See id.* at 4.

84. *Id.* at 3-4.

THE NEED FOR TAX REFORM

2. *Benefits and Challenges of Increasing Schedule K-1 E-Filing*

To use the Schedule K-1 document matching program, Schedule K-1 information must first be entered into IRS computers for analysis.⁸⁵ As such, information returns with Schedule K-1s must be either e-filed or filed on paper.⁸⁶ Any returns filed on paper must be manually transcribed by IRS staff for use in its computer system,⁸⁷ which is costly and time-consuming.⁸⁸ Thus, e-filing the information returns provides the IRS with faster, more complete information for use in the Schedule K-1 matching program and other research programs and, most importantly, eliminates transcription errors.⁸⁹ In tax year 2002, for example, fewer than 0.25% of partnerships were required to e-file because the requirement was limited to partnerships with over 100 partners.⁹⁰ Treasury Regulation (“Treas. Reg.”) § 301.6011-3(a) requires a partnership with more than 100 partners to file its partnership return (under Treas.Reg. § 1.6031(a)-1) on magnetic media.⁹¹ The Treasury Commissioner has the discretion to require these partnerships to file their returns electronically,⁹² and under Revenue Procedure (“Rev. Proc.”) 2012-17, the Treasury Commissioner requires partnerships to e-file their Schedule K-1s.⁹³ This e-filing requirement became effective on February 13, 2012.⁹⁴

Thus, the IRS has made substantial progress in making e-filing readily available, if not required. In 2003, the IRS did not have the capacity to accept all filed returns electronically.⁹⁵ On January 8, 2007, the Modernized E-File Program system was launched for Forms 1065 and 1065-B.⁹⁶ Currently, the only forms that cannot be e-filed are Forms 1040NR, 1041QFT, and 990T.⁹⁷

85. *Id.* at 7.

86. *Id.*

87. *Id.*

88. *Id.* at 20.

89. *Id.*

90. *Id.* at 7.

91. Treas. Reg. § 301.6011-3(a) (Westlaw 1999); I.R.C. § 6031 (Westlaw 2004); Treas. Reg. § 1.6031(a)-1 (Westlaw 2005).

92. Treas. Reg. § 301.6011-3(a).

93. Rev. Proc. 2012-17, § 3.01, 2012-10 I.R.B. 453; *see* GAO-04-1040, *supra* note 11, at 20.

94. Rev. Proc. 2012-17, § 14; *see* U.S. DEP'T OF THE TREASURY INTERNAL REVENUE SERV., I.R.S. INSTRUCTIONS FOR FORM 1065: U.S. RETURN OF PARTNERSHIP INCOME 3 (2013), *available at* <http://www.irs.gov/pub/irs-pdf/i1065.pdf>.

95. *See* GAO-04-1040, *supra* note 11, at 5, 20.

96. *Guidance for Amended Partnership Returns*, INTERNAL REVENUE SERV., <http://www.irs.gov/Tax-Professionals/e-File-Providers-&-Partners/Guidance-for-Amended-Partnership>Returns> (last visited Jan. 25, 2015).

97. I.R.S. Notice 2011-26, 2011-17 I.R.B. 720.

As a result of enacting § 6011(e)(3) in 2010, more taxpayers are now e-filing their tax returns.⁹⁸ Section 6011(e)(3) requires tax return preparers of Forms 1040, 1040A, 1040EZ, and 1041—who reasonably expect to file eleven or more of these returns in a calendar year after December 31, 2010—to e-file any returns they prepare during that year or request a waiver.⁹⁹ Unless a pass-through entity prepares its information returns internally, it is likely that those returns will be prepared by an outside tax return preparer who will be required to e-file the returns including Schedule K-1s. Consequently, e-filed returns would not have to go through the costly, and sometimes erroneous, manual input and transcription process. As a result, all Schedule K-1 income lines (not just the initial six) would be available for the manual audit selection and the Schedule K-1 document matching program.

Although there are some costs to both taxpayers and the IRS, e-filed Schedule K-1s offer substantial advantages for the IRS when compared to costs associated with paper-filed Schedule K-1s.¹⁰⁰ Specifically, e-filed information returns eliminate manual transcription costs and human input errors, and make all Schedule K-1 income lines available for screening and audit selection.¹⁰¹

3. *Limitations on Availability or Accuracy of Schedule K-1 Data*

An e-filed Schedule K-1 becomes part of the IRS's data automatically by virtue of electronic data submission.¹⁰² For e-filed Schedule K-1s, complete data from the information return, including complete Schedule K-1 data, becomes available to the IRS for analysis.¹⁰³

A paper-filed Schedule K-1, however, goes through a series of manual steps, including a transcription process before it is entered into the IRS's Information Return Master File,¹⁰⁴ which starts in May and can take up to six months to complete.¹⁰⁵ Moreover, unlike an e-filed Schedule K-1 in which complete data becomes readily available, IRS staff transcribe only selected line items from paper-filed returns.¹⁰⁶ The transcription process undergoes two levels of review, but less

98. See T.D. 9518, 2011-17 I.R.B. 710; *IRS E-File Launches Today; Most Taxpayers Can File Immediately*, INTERNAL REVENUE SERV. (Aug. 27, 2012), <http://www.irs.gov/uac/IRS-e-file-Launches-Today;-Most-Taxpayers-Can-File-Immediately>.

99. See T.D. 9518; I.R.C. § 6011(e)(3) (Westlaw 2010).

100. GAO-04-1040, *supra* note 11, at 20. The cost to process e-filed returns is relatively low compared to the cost of processing paper Schedule K-1s. *Id.* Specifically, for fiscal year 2001, the cost to process paper-filed Schedule K-1s was \$14.6 million, and \$13.1 million for fiscal year 2002. *Id.*

101. See *id.* at 9–15.

102. See *id.* at 20.

103. *Id.* at 18.

104. *Id.* at 8.

105. *Id.*

106. *Id.*

THE NEED FOR TAX REFORM

than 2% of all Schedule K-1s are tested for accuracy under manual quality review.¹⁰⁷ As such, the majority of filed Schedule K-1s are only assessed through the document matching program.¹⁰⁸ Since Schedule K-1s are manually transcribed, data from paper-filed Schedule K-1s contain transcription errors, which ultimately reduce the effectiveness of the Schedule K-1 document matching program.¹⁰⁹ The manual transcription errors that resulted from processing paper-filed returns ranged from 5% to 9.5% for tax year 2002;¹¹⁰ incorrectly transcribing a taxpayer's name and address was the most frequent error.¹¹¹

The next set of errors that resulted from manual transcription dealt with incorrect dollar amounts and TINs.¹¹² Even though all of these errors substantially reduce the effectiveness of the Schedule K-1 matching program, IRS officials believe that it would be inefficient to address and correct transcription errors by requiring additional manual review of Schedule K-1s or to reenter information found to be inaccurate due to transcription errors.¹¹³ Instead, IRS officials embraced the congressional mandate to increase e-filing to at least 80% of all tax and information returns, thus eliminating the need for transcription.¹¹⁴

Initially, a paper-filed or an e-filed Schedule K-1 is checked for accuracy (an upfront check) prior to the IRS's acceptance of the return.¹¹⁵ If the return does not successfully pass this initial screening, the IRS rejects it.¹¹⁶ An upfront check is general and "include[s] verifying the tax year and proper formatting of names, addresses, and TINs."¹¹⁷ For example, a partner's TIN must include a specific range of numbers established by the IRS in order for the return to be accepted prior to the TIN matching process.¹¹⁸ The specific check, however, falls short of the actual TIN validation process.¹¹⁹ Rather, as long as it was filed in the correct format, an erroneous partner TIN is accepted at this stage of the process.¹²⁰

107. *Id.*

108. *Id.* at 9.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.* at 10.

114. *Id.* at 20.

115. *Id.* at 7.

116. *Id.*

117. *Id.*

118. *Id.*

119. *See id.*

120. *See id.*

After the general upfront check, the next step of the Schedule K-1 authentication process is TIN validation.¹²¹ TIN validation is a process by which a TIN and a partner's name are matched to that taxpayer's identity information found in IRS files.¹²² If there is no match, the IRS will attempt to remedy an incorrect TIN and name combination by matching the first four characters of an individual's last name or a business name with a file that contains all Social Security numbers or all employer identification numbers ever issued (and any name ever associated with that individual or entity).¹²³ This TIN validation process, which takes place several months after the IRS accepts the return, happens four times a year beginning approximately ninety days after the end of the filing season.¹²⁴ As noted previously, the pass-through entity is not notified that the TIN on any of its Schedule K-1s is erroneous at the time of the information return's acceptance.¹²⁵ As such, a pass-through entity may determine that one of its Schedule K-1s contains an invalid TIN in one of two ways: (1) it participates in the IRS's TIN matching online process¹²⁶ prior to filing its information return; or (2) it receives a Notice 972CG several months after filing its return.¹²⁷

D. Addressing Improper TINs and Other Errors

The TIN matching was initially developed to ensure compliance with information returns.¹²⁸ Prior to submitting an information return, such as Form 1099 or Schedule K-1, a business owner participant can voluntarily check the TINs provided by the partners against the IRS database to ensure proper compliance.¹²⁹ Section 6050W and Rev. Proc. 2003-9 authorize the IRS to match TIN information online.¹³⁰ Pass-through entities that distribute reportable payments under § 3406(b)(2)—including interest and dividend payments—are considered “payors of reportable payments” and may participate in this online TIN matching program.¹³¹ As such, this program can

121. *Id.* at 9.

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *See generally* U.S. DEP'T OF THE TREASURY INTERNAL REVENUE SERV., PUBL'N 2108A, ON-LINE TAXPAYER IDENTIFICATION NUMBER (TIN) MATCHING PROGRAM (2013), *available at* <http://www.irs.gov/pub/irs-pdf/p2108a.pdf> [hereinafter PUBL'N 2108A].

127. IRM 20.1.7.3.4.11 (June 15, 2011). Notices CP2100 and CP2100A are sent for missing or incorrect TINs found on Forms W-2, 1099, or 1098. *See* U.S. DEP'T OF THE TREASURY INTERNAL REVENUE SERV., PUBL'N 1586, REASONABLE CAUSE REGULATIONS & REQUIREMENTS FOR MISSING AND INCORRECT NAME/TINs 3 (2012), *available at* <http://www.irs.gov/pub/irs-pdf/p1586.pdf>.

128. *See* PUBL'N 2108A, *supra* note 126, § 1.

129. *Id.*

130. *Id.*

131. Rev. Proc. 2003-9, § 3.01-03, 2003-1 C.B. 516.

THE NEED FOR TAX REFORM

be used by pass-through entities to check TINs included on Schedule K-1s prior to filing pass-through information returns.¹³²

If a filed Schedule K-1 nonetheless contains an incorrect TIN, the pass-through entity may be subject to penalties under § 6723 for its failure to properly report information on a return.¹³³ Section 6109¹³⁴ provides the Secretary of the Treasury with authority to prescribe regulations requiring the inclusion of TINs on tax returns.¹³⁵ For example, Treas. Reg. § 301.6109-1(b) requires taxpayers to include owners' TINs on a tax return "as required by the forms and the accompanying instructions."¹³⁶ This regulation requires pass-through entities to provide valid TINs of their owners on Forms 1065, 1120S, or 1041.¹³⁷ Finally, § 6723 establishes a penalty for failing to timely comply with the specified information reporting requirement, which includes failing to provide a valid TIN on a filed tax return.¹³⁸ Under § 6723, a taxpayer may be assessed a penalty of \$50 for each failure to provide a valid TIN, but not more than \$100,000 per tax year.¹³⁹ These penalties act as a deterrent and motivate pass-through entities to participate in the IRS's TIN matching program prior to filing their information returns.

In 2003, the IRS did not notify pass-through entities of invalid TINs after performing a TIN validation check.¹⁴⁰ Today, the IRS is required to send a notice to pass-through entities pursuant to Information Return Manual (IRM) 20.1.7 if a Schedule K-1 contains an invalid TIN.¹⁴¹ According to the IRM, taxpayers who file an information return with missing or invalid TINs are subject to a penalty of \$100 per return that was due on or after January 1, 2011.¹⁴² Furthermore, a Notice

132. *Id.* § 1.

133. I.R.S. Chief Couns. Mem. POSTF-121071-05 (June 2, 2005). Section 6723 provides:

In the case of a failure by any person to comply with a specified information reporting requirement on or before the time prescribed therefor, such person shall pay a penalty of \$50 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed \$100,000.

I.R.C. § 6723 (Westlaw 1989).

134. Section 6109(a)(1) provides: "When required by regulations prescribed by the Secretary: [a]ny person required under the authority of this title to make a return, statement, or other document shall include in such return, statement, or other document such identifying number as may be prescribed for securing proper identification of such person." *Id.* § 6109(a)(1) (Westlaw 2009).

135. *Id.*

136. Treas. Reg. § 301.6109-1(b) (Westlaw 2013).

137. *See id.*

138. I.R.C. § 6723.

139. *Id.*

140. *See* GAO-04-1040, *supra* note 11, at 14.

141. IRM 20.1.7.1.1(2) (July 15, 2011). This particular section of the IRM outlines policies and procedures for the application of information return penalties under § 6721. *Id.* at 20.1.7.1; *see* I.R.C. § 6721 (Westlaw 2010).

142. IRM 20.1.7.3.4.9 (July 15, 2011).

972CG—Notice of Proposed Civil Penalty, which provides notice to taxpayers as to the proposed penalties for missing and incorrect TINs¹⁴³—is mailed to provide taxpayers with “an opportunity to establish reasonable cause for waiver of penalties prior to assessment.”¹⁴⁴ A taxpayer’s use of the TIN matching program can establish reasonable cause by providing affirmative evidence that the taxpayer had made every effort to verify and locate the correct TINs for each of its partners through the use of the most comprehensive TIN database available—the TIN matching program.¹⁴⁵

To effectively use Schedule K-1 data in the document matching program, the TINs and names on Schedule K-1s must be accurate in order to link them to the correct Form 1040.¹⁴⁶ In tax year 2002, for example, 6% of all processed Schedule K-1s—approximately 1.5 million—contained an invalid TIN.¹⁴⁷ Through its TIN validation program, the IRS discovered that approximately 7% of e-filed Schedule K-1s contained invalid TINs whereas approximately 6% of paper-filed Schedule K-1s contained invalid TINs.¹⁴⁸ According to the IRS, 1.5 million filed Schedule K-1s contained incorrect TINs. These identified Schedule K-1s reported combined gains of \$57.3 billion and combined losses of \$84.1 billion.¹⁴⁹ Through the TIN matching program, the IRS successfully corrected TINs on approximately 750,000 Schedule K-1s. These corrections amounted to combined income gains of \$20.6 billion and losses of \$6.8 billion.¹⁵⁰ However, the remaining 740,000 Schedule K-1s containing invalid TINs could not be corrected and could not be used in the program.¹⁵¹ Thus, the effectiveness of the Schedule K-1 document matching program strongly depends on the availability of correct and valid TINs. Without valid TINs, Schedule K-1 data cannot be used in the program.

Any Schedule K-1 data entered into the IRS computer system with a valid TIN will subsequently be used in the matching program. The IRS conducts its document matching once a year, generally from November of any given calendar year through January of the following year.¹⁵² Therefore, inaccurate TINs not only hinder the effectiveness of the program, but also preclude effective audits by preventing auditors from tracing income flowing through related entities.¹⁵³ As such, the IRS is unable to

143. IRM 20.1.7.3.4.11 (July 15, 2011).

144. *Id.*

145. PUBL’N 2108A, *supra* note 126, § 12.

146. *See* GAO-04-1040, *supra* note 11, at 11.

147. *Id.*

148. *Id.* at 12.

149. *Id.* at 11–12.

150. *Id.* at 12.

151. *Id.*

152. *Id.* at 14.

153. *See id.* at 16.

THE NEED FOR TAX REFORM

effectively use its Schedule K-1 document matching program to discover non-compliant taxpayers and tax schemes.¹⁵⁴

E. The Program is Not Improving

In September 2006, the TIGTA once again revisited the issue of the IRS's Schedule K-1 document matching program and issued a report assessing its effectiveness.¹⁵⁵ TIGTA noted that despite the IRS's changes to make the program more effective, the screen-out and no-change rates remained high.¹⁵⁶ Specifically, by March 31, 2006, the IRS had issued close to 71,000 notices to taxpayers assessing additional income for tax year 2003.¹⁵⁷ However, the no-change rates for tax year 2003 did not improve and actually increased from 33% in tax year 2002 to 37%.¹⁵⁸ Clearly, despite the attempted changes, the Schedule K-1 document matching program remains ineffective.¹⁵⁹

This is largely due to the difficulty of its administration, which includes manual transcription errors from paper-filed returns, incorrect TINs, and the matching of only the first six income lines of Schedule K-1.¹⁶⁰ Schedule K-1 income and deduction items cannot be traced as easily as wages or pension distributions because Schedule K-1 is a separate schedule, and items of income and deductions can be included on various schedules, such as Schedule E.¹⁶¹ Moreover, much of the program relies on an extensive manual selection process, which inevitably leads to errors and reduces the effectiveness of the IRS's audits.¹⁶² For example, properly identifying fiscal year returns when they are initially processed remains an issue. To use its document matching program effectively, the IRS must properly classify Schedule K-1s as fiscal year returns.¹⁶³ Pursuant to the TIGTA report, even e-filed fiscal year Schedule K-1s were not properly identified according to the fiscal year in which they were initially processed.¹⁶⁴ In addition, many of the no-change assessment cases resulted from the fact that taxpayers continue to improperly net pass-through items on their individual tax returns.¹⁶⁵ The

154. *Id.*

155. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2006-30-159, THE SCHEDULE K-1 MATCHING PROGRAM HAS BEEN IMPROVED, BUT MORE CAN BE DONE TO INCREASE ITS EFFECTIVENESS (Sept. 25, 2006), available at <http://www.treasury.gov/tigta/auditreports/2006reports/200630159fr.pdf>.

156. *Id.* at 4. A screen-out rate is the rate of selecting tax returns for an audit using the Automated Underreporter Program or other document matching programs. *See id.*

157. *Id.* at 1.

158. *Id.* at 1, 4.

159. *See id.*

160. *See id.* at 5.

161. *Id.* at 3.

162. *Id.* at 4.

163. *Id.* at 5.

164. *See id.*

165. *See id.* at 6.

TIGTA recommended that the IRS continue addressing the errors identified and continue educating taxpayers on the proper ways of offsetting income reported on Schedule K-1 when it is entered onto Schedule E.¹⁶⁶

Finally, in another report issued in December 2012, the TIGTA stated that the IRS's Modernization Program—which deals with internal system access controls, configuration management, audit trails, and physical security—needs improvement.¹⁶⁷ In addition, the TIGTA explained that the weaknesses in the IRS's information technology programs resulted from its reliance on inefficient software applications and matching programs that provide inaccurate non-compliance information.¹⁶⁸ The TIGTA report stressed the need for a modern information technology system to increase IRS efficiency and reduce taxpayer burden.¹⁶⁹ Without these substantial improvements, the Schedule K-1 document matching program will continue to be ineffective.

IV. A FEASIBLE SOLUTION

The Schedule K-1 document matching program has been revised several times, yet remains ineffective due to the difficulty of its administration. One of the current tax reform proposals suggests that a withholding tax at the pass-through entity level would be more efficient.¹⁷⁰ If implemented, revenue would be collected at the entity level from a much smaller pool of pass-through entities instead of from a greater number of individual taxpayers.¹⁷¹

Other possible solutions include simplifying Schedule K-1 and Schedule E reporting even further, or improving and redeveloping the IRS's document matching program software. Both solutions are more costly than a mandatory entity level withholding and would require special budget requests from Congress. These solutions would also require extensive studies and time commitments, and would not result in a near-future solution.

V. CONCLUSION

Tax reform must center around effective revenue collection, cost savings, and effective voluntary compliance. As such, an effective Schedule K-1 document matching program is imperative. Today, the no-change rates are high and assessment

166. *Id.*

167. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2012-20-120, ANNUAL ASSESSMENT OF THE INTERNAL REVENUE SERVICE INFORMATION TECHNOLOGY PROGRAM 7 (Sept. 28, 2012), *available at* <http://www.treasury.gov/tigta/auditreports/2012reports/201220120fr.pdf> [hereinafter TIGTA, 2012-20-120].

168. *Id.* at 6–7; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-695, INTERNAL REVENUE SERVICE: STATUS OF GAO FINANCIAL AUDIT AND RELATED FINANCIAL MANAGEMENT RECOMMENDATIONS 8 (June 2012), *available at* <http://www.gao.gov/assets/600/592015.pdf>.

169. TIGTA, 2012-20-120, *supra* note 167, at 7.

170. Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1341 (2013).

171. *Id.*

THE NEED FOR TAX REFORM

rates are low. If returns are filed on paper, the Schedule K-1 program is impaired due to transcription errors. E-filed and paper returns also impair the program because of the inclusion of incorrect TINs in Schedule K-1s. Moreover, the program's matching process is incomplete, matching only the first six lines of Schedule K-1. It does not include line 10 (other income), which is commonly used by taxpayers to include other unclassified income.

The matching process takes place only once a year, but relies substantially on manual return review selection, which inevitably results in errors and omissions. Simplifying Schedule K-1 and Schedule E reporting could lead to more transparency and an easier matching process.

In addition, improving the IRS's information technology programs and software should be explored. Without meaningful improvements to the Schedule K-1 document matching program, the IRS is missing the opportunity to improve the accuracy of TINs associated with Schedule K-1s, which undermines the benefits that can be gained from the program, efficient targeting of audits, and new research identifying non-compliance schemes. The most effective solution would likely be to abandon the Schedule K-1 document matching program in favor of an entity level withholding tax.