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The Honorable Daniel P. Moynihan
Ranking Minority Member
Committee on Finance
United States Senate

Subject: Internal Revenue Service: Preparing Substitute for Returns for Individuals

Dear Senator Moynihan:

On November 22, 1999, we briefed your office about the Substitute for Return (SFR) program at the Internal Revenue Service (IRS). In accordance with statutory authority granted to the Secretary of the Treasury and his designees, IRS prepares a substitute for return for individuals who do not appear to have filed a required tax return (i.e., potential nonfilers). IRS prepares these substitute for returns using information maintained in IRS' computer files.[1]

This letter summarizes the points we made at the briefing and answers six questions raised by your office. To prepare the briefing, we used information about nonfilers and the SFR program that we had collected during previous work. To answer questions raised at the briefing, we interviewed responsible IRS officials in the Customer Service and Collection Divisions at the National Office. We also reviewed related IRS documents. We did our work in Washington, D.C., and New Carrollton, Maryland, from November 1999 through January 2000 in accordance with generally accepted government auditing standards.

Results in Brief

As discussed at the briefing, IRS prepares a substitute for return for certain individuals classified as potential nonfilers for whom (1) it has what it considers to be adequate information about income and (2) the estimated tax liability is at or above a certain level. IRS receives this income information from third parties, such as banks and employers, who make payments to individuals. IRS believes that potential nonfilers who receive a substitute for return will be encouraged to respond by either filing a more accurate return or showing that they have no filing requirement. IRS is to give the potential nonfilers up to two chances to

[1] In its response to this letter, IRS officials indicated that they do not generally prepare actual tax returns. Instead, they said IRS prepares substitute documents that propose assessments. Although IRS and legislation refer to this as the substitute for return program, these officials said that the document does not look like an actual tax return.

respond to information showing the proposed amount of the substitute for return. If these individuals do not respond, IRS is to assess the tax shown on the substitute for return and seek payment of the balance due through its regular collection process. Enclosure I contains more detailed information about these and other points made at the briefing.

In response to questions raised at the briefing:

- IRS can contact potential nonfilers who are not selected for the SFR program to solicit a tax return. These contacts can be made through telephone calls or visits by IRS staff.
- IRS has a few criteria to guide decisions on whether to create a substitute for return through automated or manual means. IRS is to use the automated method rather than the manual method when the sources of income are less complex, such as when they have little or no self-employment income from business activities. The automated method accounts for most substitute for returns.
- When preparing a substitute for return, IRS allows for a filing status of either "single" or, if the most recently filed return showed the taxpayer as married, "married filing separately." According to IRS officials, IRS has always allowed for only these two filing status claims on a substitute for return. IRS cannot use "married filing jointly" because the tax law only allows this filing status when taxpayers elect to use it upon filing a tax return.
- IRS rarely receives information other than income information from third parties in preparing a substitute for return.
- A balance-due account created from a substitute for return has no special priority over those created through other means. IRS is to use the same formula to set collection priorities for all types of accounts that involve the collection of unpaid assessments from individuals.
- IRS does not routinely collect data on the costs to prepare and process substitute for returns and on the impacts of the SFR program on compliance. For example, IRS does not collect data on whether the taxpayer files for future tax years. IRS does track the number of substitute for returns and whether the taxpayer responds to the notice on the related tax, penalty, and interest assessments.

Enclosure II responds to these questions in more detail.

Agency Comments

We requested comments on a draft of this letter from the Commissioner of Internal Revenue or his designee. On February 9, 2000, we received comments from responsible IRS officials in the Examination and Customer Service Divisions. Although the Examination Division said it had no comments, Customer Service Division officials commented on the phrase "Substitute for Return." They asked us to emphasize that even though the program is commonly referred to as the SFR program, no actual tax return is prepared. Instead, these officials noted that IRS prepares a document that substitutes for the return and that proposes an assessment, which is posted to the taxpayer's account and is subject to the collection process. We added a footnote to the letter to explain this and revised references in the draft to clarify this point.

Unless you publicly announce its contents earlier, we plan no further distribution of this letter until 15 days after its date. We will then send copies to Senator William V. Roth, Jr., Chairman, Committee on Finance, and Representatives William Archer, Chairman, and Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means. We also will send copies to the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; and other interested parties.

A key contributor to this report was Louis Roberts. If you have any questions, please contact me or Tom Short on (202) 512-9110.

Sincerely yours,

Cornelia M. Ashby

Cornelia M. Ashby
Associate Director, Tax Policy and
Administration Issues

Information Presented at the Briefing

Our November 22, 1999, briefing covered (1) IRS' methods for identifying potential nonfilers, (2) the purpose of the Substitute for Return (SFR) program, (3) the criteria for selecting potential nonfilers for the program, (4) rules guiding the preparation of a substitute for return, and (5) the process for contacting the potential nonfilers about substitute for returns.

Identifying Potential Nonfilers

In general, individual taxpayers are required to file an income tax return, regardless of whether they actually owe any tax, when their gross income during a year exceeds the amount allowed for their personal exemption and standard deduction. If IRS has identified a filing requirement for individuals who have not filed a tax return, IRS is likely to identify them as a potential nonfiler.

IRS uses various methods to identify potential nonfilers. In one method, IRS can use information returns (e.g., Forms W-2 and 1099) filed by employers, banks, and other third parties to report various types of payments to individuals. These payments include wages, interest, and dividends as well as some payments to self-employed individuals for services rendered.[1] In the other methods, IRS can identify nonfilers through its audits of related returns or its computerized checks to identify individuals who filed for the previous year but not the current year.

In recent years, IRS has been contacting about 2 million potential nonfilers per year. The number contacted in any year depends on such factors as the projected tax liabilities of the potential nonfilers and IRS' available staffing. These individuals are to receive up to two notices at an 8-week interval. The notices ask them to either file a return or provide evidence that they have no filing requirement.

Purpose of the SFR Program

If individuals have not responded as asked to one of the two initial notices, they may become subject to the SFR program if IRS has sufficient income information from the information returns filed for these individuals. IRS' goal is to file a substitute for return that reports a tax liability at least equal to the amount of the true liability, recognizing that the potential nonfiler has the most complete information about the liability. For example, individuals would have information on other types of income and reductions to income, such as tax deductions, business expenses, exemptions, and credits. IRS believes that such a substitute for return will

[1]Not all service payments to self-employed individuals are subject to information return reporting. For example, if the payments are less than $600 for a calendar year, an information return is not required to be filed.

encourage potential nonfilers to respond by either filing an accurate return or providing evidence of no filing requirement.

Selection Criteria for the SFR Program

Potential nonfilers must meet certain criteria to be selected for the SFR program. In general, these criteria are designed to ensure that substitute for returns are selected from a group where the net balance due exceeds a specified minimum. The number of cases actually worked is determined by the resources available to process the substitute for returns.

IRS can create a substitute for return for the potential nonfiler if it has evidence of the major sources of income, particularly from nonbusiness-related sources, such as wages, interest, and dividend income. IRS also can create substitute for returns if it has evidence that the amount of income and estimated tax liabilities owed are high enough.

For example, under its automated program, IRS can prepare substitute for returns for nonfilers who (1) have an estimated net balance due of $500 or more and less than 30 percent in business-related income, (2) have income of $100,000 or more with no business-related income, or (3) are federal or state government employees or retirees with an estimated net balance due of $100 or more. Also, the potential nonfiler cannot owe taxes for a previous period. IRS staff sometimes manually prepares a substitute for return if the evidence shows a substantial amount of business-related income.

Rules Guiding the Preparation of Substitute for Returns

IRS has a few simple rules to guide its preparation of substitute for returns. The income shown on information returns is to be included in the substitute for return. All substitute for returns are to be given a filing status of single unless the most recently filed return shows the individual was married. In this case, the filing status is to be "married filing separately." The only deductions from income allowed are the personal exemption, standard deduction amounts for the filing status used, and the 50-percent adjustment to income allowed for self-employment tax paid on business income. All other deductions are considered to be elections for which the taxpayer must file a return.

IRS Contacts With Potential Nonfilers About Substitute for Returns

IRS is to make multiple contacts with potential nonfilers about their tax liability on the substitute for return. Overall, these contacts can take 7 to 9 months. Major types of contacts follow.

- IRS first is to send a "30-day letter" that includes a proposed assessment of tax, penalty, and interest. The letter is to instruct the individual on possible ways to respond, such as accepting the proposed assessment; filing an original return; providing evidence that there is no filing requirement; or appealing the proposed assessment to IRS' Office of Appeals. IRS asks for one of these responses within 30 days but usually allows more time to reduce the chances of sending another notice to an individual who has already responded.

- If no response is received to the 30-day letter within the allotted time, IRS is to send a 90-day statutory notice. The statutory notice is to contain information similar to the 30-day letter and information on the taxpayer's right to petition the Tax Court. IRS usually allows more than the 90 days cited in this notice for potential nonfilers to respond.
- If IRS does not receive a response within the allotted time, the tax, penalty, and interest on the substitute for return are to be assessed. IRS also is to send up to four balance-due notices at 5-week intervals for the amount owed.
- Six weeks after the fourth balance-due notice, IRS is to forward any unpaid accounts to IRS staff, who are to try to collect the unpaid amounts through phone calls to the individual. IRS also can take other collection actions if these potential nonfilers do not respond to the calls.

Response to Briefing Questions

During our November 22, 1999, briefing, several questions arose that required some work to answer. Following are the responses to these questions.

How Does IRS Deal With Potential Nonfilers Who Are Not Selected to Receive Substitute for Returns?

If nonfiler cases are not handled in the SFR program, IRS may send the cases to the Automated Collection System (ACS) or to a field office to be worked by a revenue officer or revenue agent. For tax year 1996, IRS sent initial notices to about two million potential nonfilers. Over 750,000 of these individuals then filed a return or responded to one of the two initial notices by showing that they had already filed or were not required to file. About 1.7 million taxpayers did not respond. These cases had a substitute for return prepared, were sent to ACS, were referred to field offices to be worked by revenue officers, or were closed with no further action.

Nonfiler cases sent to ACS are to be handled by IRS staff who call the potential nonfilers to try to get them to file a return or show why no return needed to be filed. If this effort fails, the case may be referred to the field or closed.

IRS also associates nonfiler cases with open balance-due cases already in the field inventory. Revenue officers will attempt to resolve these nonfiler cases while they are addressing the balance-due case. If revenue officers have difficulty in securing a voluntarily filed return, they can use summons authority to compel the potential nonfiler to provide books and records from which a substitute for return can be prepared.

What Criteria Guide Decisions on Whether to Create a Substitute for Return Through Automated or Manual Processes?

IRS prepares a substitute for return through either automated or manual processes. The primary difference between the manual and automated processes involves the type of income.[1] Under its criteria, IRS is to use the automated process when less than 30 percent of the income reported for potential nonfilers comes from self-employment. Manually prepared substitute for returns generally include a higher percentage of self-employment income and have no limits on the income percentage.

Additionally, the automated process is to focus on specific types of potential nonfilers. Such nonfilers include those who have more than $100,000 in income of which none of it comes from self-employment or who are federal or state government employees or retirees. The manual

[1]Even with the differences, the automated and manual processes have similarities. For both, IRS wants a high enough estimated balance due to cover program costs. Also, IRS needs to have enough information to prepare a return that is likely to include most of the taxpayer's income.

process does not have criteria that focus on specific types of potential nonfilers.

Also, manually-created substitute for returns can be initiated by revenue officers and others in the nonfiler program or by other sources, such as examinations of related returns. Automated substitute returns come entirely from the early stages of the nonfiler program, when potential nonfilers are identified and the initial notices are sent.

In Preparing Returns, When Did IRS First Allow for a "Married Filing Separately" Status and Why?

According to IRS officials, they have always used the "married filing separately" status. This filing status is to be applied to a substitute for return when the individual's most recently filed return indicates that the individual was married. In all other substitute for return situations, IRS is to calculate the tax liability using a single filing status.

According to IRS officials, the "married filing separately" status is used because only the taxpayer can elect to claim the "married filing jointly" status. Also, using the "married filing separately" status is to encourage the potential nonfilers to file a correct return if they can claim the "married filing jointly" status. The election to use this filing status is likely to result in a lower tax liability.

Does IRS Have Information Other Than Income Information to Use in Preparing a More Accurate Substitute for Return?

IRS generally does not have additional information that would allow it to prepare a more accurate substitute for return. For example, IRS does not receive information on how much an individual might have accumulated in business deductions or most other tax deductions. The only itemized deduction item on which IRS may get information is an individual's mortgage interest deduction. IRS does not use the mortgage interest amount as a deduction because it is an elective deduction and the individual must file a return to claim it.

IRS also does not use information from the taxpayer's most recent return. This information includes marital status and dependent data. However, IRS has no assurance that this information is accurate for the current tax year. For example, the taxpayer may have had children move out of the household or otherwise lose their qualifications as dependents.

What Priority Does IRS Give a Balance-Due Account Created Through a Substitute for Return in the Collection Process?

Balance-due accounts created through the SFR program have no special collection priority over other types of balance-due accounts for individuals. IRS prioritizes its efforts to collect balance-due amounts for individuals through a scoring system. That system is based on a formula that relies primarily on the amount of the unpaid assessments. IRS is to use this same formula to set the priority for balance-due amounts created through SFR as well as for other types of unpaid amounts by individuals.

What Data About SFR Costs, Caseload, and Results Are Collected and What Analyses Are Done to Determine Whether the SFR Program Works?

IRS collects data on the nonfiler process, including the number of substitute for returns prepared. Specifically, IRS maintains SFR information on the

- number of notices sent to potential nonfilers,
- number of returns received in response to the notices,
- amount of assessments and abatements made, and
- amount of assessments collected over time.

IRS maintains information on the amounts collected in its Enforcement Revenue Information System. This system, in addition to identifying collection and refund amounts, also shows the revenue amounts generated specifically through enforcement actions.

IRS maintains budget data for the groups that prepare and process substitute for returns but does not routinely track the costs of the SFR process. According to IRS officials, IRS uses these data to plan the SFR workload given the resources available but does not routinely evaluate the SFR program. Nor does IRS routinely collect data on program impacts. For example, IRS does not collect data on whether individuals having a substitute for return prepared by IRS continue to be nonfilers or start regularly filing returns as required by law.

Instead, IRS periodically does one-time evaluations of some part of the SFR program. For example, IRS' Office of Internal Audit and, more recently, the Treasury Inspector General for Tax Administration have evaluated aspects of the process. The latter group is looking at how effectively IRS is using the available SFR information to monitor and evaluate program operations. The final report from this work is to be available in March 2000. IRS officials also referred to other ongoing or planned studies elsewhere within IRS.

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