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WOULD EXPANDED 1099-MISC REPORTING NARROW THE TAX GAP WITHOUT UNREASONABLY INCREASING BUSINESSES' PAPERWORK COSTS?

Executive Summary

The federal government requires businesses to notify the IRS on Form 1099-MISC if they have paid various types of miscellaneous income to service providers (with one copy of each 1099-MISC going to the IRS, another to the service provider, and a third retained for the business's own records). Like better known third-party reporting forms, such as the W2, the 1099-INT, and the 1099-DIV, the 1099-MISC is a tax-enforcement tool: taxpayers are less likely to omit income from their tax returns if they know the IRS has third-party information concerning the income.

A major exception to the 1099-MISC reporting requirement is that the form usually does not have to be submitted if the payee is a corporation. The Government Accountability Office (GAO) recommends eliminating the payments-to-corporations exception because doing so would slightly narrow the tax gap (the difference between taxes owed and tax payments the IRS receives.) Although GAO is correct regarding improved tax enforcement, forcing businesses to act as unpaid assistants to the IRS raises their already high tax-paperwork costs. A compromise might be to retain the payments-to-corporations exemption for small businesses because they often lack economies of scale in tax compliance but remove the exemption for large businesses.

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In January, the Government Accountability Office (GAO) issued a report on IRS Form 1099-MISC.[1] Conducted at the request of the Senate Finance Committee, the study examined whether businesses should be encouraged or required to file more 1099-MISCs as a way to improve tax enforcement.

Form 1099-MISC reporting and exceptions

Like the better known 1099-INT (for interest income) and 1099-DIV (for dividend income), the 1099-MISC is an information-reporting form. A trade or business must submit a 1099-MISC to the IRS for each person to whom it pays certain types of income during the year (with a copy going to the payee and another copy retained for the business's own records.)

For instance, a trade or business might be obliged to submit a 1099-MISC if it gives a $1,500 honorarium to a dinner speaker, writes $15,000 of rent checks to its landlord during the year, or pays $10,000 to an independent contractor. The trade or business submitting the 1099-MISC must, on the form, identify itself, the recipient, the amount paid, and the type of income (within several broad categories). Some of the types of miscellaneous income to which Form 1099-MISC applies are fees, commissions, awards, and other compensation for services performed for the business by non-employees, health care payments, gross proceeds the business pays to an attorney, rent payments, royalty payments, and crop insurance proceeds.[2] In most categories, the trade or business must submit a 1099-MISC for each person to whom it makes total payments during the year of $600 or more, but the floor is lower in some categories, such as royalties and gross proceeds paid to an attorney. The form must normally be sent to the recipient of the payment by January 31 of the following year and be submitted to the IRS by February 28 if filing by paper or March 31 if filing electronically.[3]

The reporting requirement has many exceptions. Some of the examples mentioned in the IRS instructions accompanying the 1099-MISC are that businesses generally should not submit the form for: payments they make to corporations,[4] payments for merchandise or telephone service, employees' business travel allowances (those are sometimes reportable on Form W-2), or payments to tax-exempt organizations. Form 1099-MISC also does not apply to employees' wages, which must be reported, instead, on Form W-2.

GAO noted, "For tax year 2006, more than 5 million payers submitted more than 82 million 1099-MISCs to IRS, reporting over $6 trillion in payments."[5] Non-employee compensation was the largest category; it comprised about 55% of submissions and almost 40% of payments. Medical payments was the next biggest category, comprising about 25% of submissions and almost 20% of payments.

Most of the approximately 50 million small businesses filing income tax returns did not submit any 1099-MISCs. One of the main reasons is the payments-to-corporations exemption. The other exemptions also reduced the number of required submissions. In addition, GAO and the IRS suspect that many businesses submitted fewer 1099-MISCs than were due, although GAO cautioned, "IRS does not know the magnitude of 1099-MISC payer noncompliance or the characteristics of payers that fail to comply."[6] Ironically, the strongest evidence of omitted 1099-MISCs has come from studies of the government sector, not the private sector, which indicated that federal government agencies "failed to submit required 1099-MISCs covering billions of dollars of payments" and suggested that some state and local governments were also derelict.[7] GAO suspects the complexity of having to "navigate through 8 pages of singled-spaced instructions to determine what to report in the 14 boxes on the 1099-MISC" confuses some payers and reduces the submission rate.[8]

GAO proposes repealing the payments-to-corporations exception

In its January 2009 report, GAO study offered a number of recommendations, such as having the IRS develop better data on 1099-MISC noncompliance (a sensible idea), expanding a program that sends reminders to payers who submitted 1099-MISCs previously but have stopped doing so, and exploring whether filers should be allowed to submit 1099-MISCs printed out on their own computers instead of having to use special "red ink" forms supplied by the IRS. The main recommendation, which is also the most controversial, is that the payments-to-corporations exemption be abolished.

Because the payments-to-corporations exception is based on regulation rather than statute,[9] the U.S. Treasury could repeal the exemption on its own initiative. However, the Treasury prefers to leave the decision to Congress because, as the IRS's National Taxpayer Advocate explained, the regulation "has been in place for many years during which Congress has made changes to the information reporting rules..."[10]

Requiring businesses to send information reports to the IRS showing their payments to corporations is not a new idea. A GAO report in 1991 concluded it would be a cost-effective enforcement tool from the IRS's perspective, while acknowledging that it would add to businesses' paperwork costs.[11] In a 2007 report, GAO described third-party information reporting as "a proven approach for improving tax compliance" and claimed the paperwork costs for business required to submit information returns are "relatively low," with the costs per submission falling rapidly as businesses increase in size (i.e., pronounced economies of scale).[12] In both its fiscal year 2008 and 2009 budgets, the Bush Administration proposed abolishing the payments-to-corporations exemption, as one of several changes to expand information reporting. The Obama Administration likewise recommends eliminating the payments-to-corporations exception.[13] The U.S. Treasury Department estimates that, through strengthened tax enforcement, requiring payers to file 1099-MISCs for service payments of $600 or more to corporations would boost tax collections by more than $9 billion during the 10-year period 2010-2019.[14]

Senator Max Baucus (D-MT) Chairman of the Senate Finance Committee, responded enthusiastically to GAO's suggestion in its January 2009 report that businesses be required to send 1099-MISC forms to the IRS showing their payments to corporations. He called it "a good and simple recommendation" and continued, "When the IRS can [use 1099-MISCs to] match up what a business pays and what is received on the other end, it can do its job in making sure it collects the right amount of taxes under the law."[15]

Third-party reporting is attractive to government budgeteers and tax collectors because, as Senator Baucus noted, the ability to match the receipts that taxpayers declare against the payments that third parties report is a powerful enforcement tool. In cases where taxpayers understate their receipts, the government can sometimes use the matching to spot the evasion and levy taxes and penalties. Just as important, third-party reporting has a prophylactic effect in that taxpayers are less likely to try concealing income if the government already has third-party information on the income.

The IRS estimated that, for tax year 2001, income misreporting was only about 1% for wage and salary income, which is generally subject to third-party reporting and withholding, less than 5% for income subject to substantial third-party reporting, such as interest and dividends, but 54% for income on which there is little or no reporting, such as informal supplier income and farm income.[16] One should take the specific numbers with a grain of salt because they are only rough estimates. However, they do indicate that third-party reporting improves tax compliance and reduces evasion.

The IRS estimated the tax gap (the difference between taxes paid and what should have been paid) was $290 billion in 2001 (the latest year for which an estimate is available).[17] Expanded third-party reporting could reduce the gap by several billion dollars yearly.

A "half-a-loaf" compromise would be better than total elimination of the exemption

However, although information reporting is convenient for the government, it should not be carried out without limit because it does place burdens on businesses and individuals. Most obviously, it creates paperwork costs for those required to submit the information. Additionally, if information forms are incorrect (and some inevitably are), payees and payers have the expense of trying to correct the errors. (This is especially aggravating to payees if a 1099 or W-2 mistakenly lists more income that was received and the payee worries the government will demand tax on the nonexistent income unless the mistake can be cleared up.) Further, as the government gathers progressively more financial information, people lose some of their privacy and personal freedom. Hence, a balance should be struck between tax enforcement and the tax system's paperwork burden.

With regard to whether 1099-MISC reporting should be extended to payments to corporations, privacy is less of a concern than it would be if the recipients were households. Similarly, payees that are corporations would be better able to cope with incorrect 1099-MISCs than noncorporate businesses or individuals because corporations are, on the whole, more knowledgeable about how to correct accounting errors than the average taxpayer. A major concern, though, is that removing the payments-to-corporations exemption would place a substantial new paperwork burden on payers; they would suddenly have to prepare and submit a large number of additional 1099-MISCs.

At present, Form 1099-MISC is a relatively small cost for businesses because most businesses need to submit only a few 1099-MISCs or none at all.[18] Even at large companies that must submit many 1099-MISCs, the 1099s are usually responsible for only a small portion of total tax paperwork costs. Without the payments-to-corporations exemption, however, a trade or business would have to assess whether it needs to prepare and file a 1099-MISC every time it pays a company $600 or more over the course of the year. The number of 1099-MISCs would mushroom.

The heightened tax-compliance costs would be especially burdensome for small businesses because they lack economies of scale both in understanding tax rules and in preparing tax paperwork. According to one study, the cost of income tax compliance is many times greater, per dollar of business assets, for a small business as for a large business.[19] For many small businesses, the abolition of the corporate-payments exemption would transform the 1099-MISC from a minor nuisance into a major headache.[20]

Fortunately, if Congress decides to expand the use of Form 1099-MISC in an effort to narrow the tax gap, a compromise exists that would significantly expand information reporting without adding to the tax-compliance burden on small businesses. The compromise, which is one of several mitigation options GAO has mentioned in the past, would be to retain the current-law exemption on payments to corporations for small businesses but remove it for large ones.[21]

By way of illustration, suppose the threshold for removing the exemption is set at gross revenue of $5 million in a base year. A trade or business with less than $5 million of gross revenue would not have to start issuing 1099-MISCs for the payments it makes to corporations for services. On the other hand, a trade or business with more than $5 million of gross revenue, which probably has a dedicated accounting department and some tax expertise, would need to begin submitting 1099-MISCs on its payments to corporations for services. To be clear, the threshold would be based on the revenue of the payer, not the recipient, because it is the payer who incurs the expense of preparing the 1099.

Regrettably, the already high tax-paperwork costs of some businesses would still increase. But at least this approach would require additional 1099-MISCs only from the businesses that, because of economies of scale in tax preparation, have the lowest costs of preparing extra 1099-MISCs.[22]

Tempering an expansion of information reporting with a sensitivity to businesses' paperwork expenses seems particularly appropriate given GAO's acknowledgment that the "IRS is not planning an exact match anyway but only a trigger for questions."[23]

Although tax enforcers might perhaps complain that this approach would not be fully comprehensive, which is true, it would furnish significantly more information reporting than does current law. The flow of new information to the IRS would be especially large because high-revenue businesses, although few in number, account for a substantial share of total economic activity and total payments for services.

If Congress narrows the payments-to-corporation exemption for private businesses, it should institute similar rules for the payments that federal, state, and local governments make to corporations, in order to improve tax compliance by government suppliers.[24]

At the same time, Congress should reexamine the payment amount, generally $600, above which a 1099-MISC may need to be filed. Because of inflation, the minimum amount that triggers a 1099-MISC has declined sharply in real dollars over time. Realistically, though, a Congress trying to boost tax collections through tighter enforcement is unlikely to adjust the reporting threshold for inflation.

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Endnotes

1. U.S. Government Accountability Office, "IRS Could Do More to Promote Compliance By Third Parties With Miscellaneous Income Reporting Requirements," Report to the Committee on Finance, U.S. Senate, GAO-09-238, January 2009, accessed at http://www.gao.gov/new.items/d09238.pdf.

2. For a fuller discussion and more examples, see Internal Revenue Service, "Instructions for Form 1099-MISC, Miscellaneous Income," accessed via http://www.irs.gov.

3. For the deadlines, see Internal Revenue Service, "General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G," p. 17, accessed via http://www.irs.gov.

4. Exceptions to the exception are that attorneys fees, some medical and health care payments, and some other payments must still be reported on Form 1099-MISC even if paid to corporations.

5. GAO, "Miscellaneous Income Reporting," p. 9.

6. GAO, "Miscellaneous Income Reporting," p. 3.

7. GAO, "Miscellaneous Income Reporting," p. 2. The studies GAO cited are: GAO, "Tax Administration: More Can Be Done To Ensure Federal Agencies File Accurate Information Returns," GAO-04-74, Dec. 5, 2003, accessed at http://www.gao.gov/new.items/d0474.pdf; and Treasury Inspector General for Tax Administration, "More Complete And Accurate Data Are Needed To Assess The Impact Of Actions To Address Compliance Reporting Of State And Local Government Entities," Reference No. 2007-10-081, June 8, 2007, accessed at http://www.treas.gov/tigta/auditreports/2007reports/200710081fr.pdf. A recent audit by the Office of Inspector General (OIG) at the National Labor Relations Board provides a case study of careless reporting by a government agency. The OIG determined that the Board should have filed 247 1099-MISCs for payments to vendors in 2007, but failed to file 19 of them. Additionally, of the 1099-MISCs that the Board did submit, 14 erred by overstating payments to vendors and 14 erred by understating payments. (OIG, National Labor Relations Board, "Subject: Inspection Report No. OIG-INS-52-08-01: Tax Gap," March 18, 2008, accessed at http://www.nlrb.gov/nlrb/about/ig/reports/OIG-INS-52-08-01.pdf.)

8. GAO, "Miscellaneous Income Reporting," p. 27.

9. See Treasury Reg.§ 1.6041-3(p)(1) and 1.6049-4(c)(1)(ii)(A).

10. National Taxpayer Advocate, Internal Revenue Service, "2007 Annual Report To Congress," Vol. 1, Legislative Recommendations, p. 495, Jan. 9, 2008, accessed at http://www.irs.gov/pub/irs-utl/arc_2007_vol_1_legislativerec.pdf.

11. GAO, "Benefits Of A Corporate Document Matching Program Exceed The Costs," Report to the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee On Government Operations, House of Representatives, GAO/GGD-91-118, September 1991, accessed at http://www.gao.gov/cgi-bin/getrpt?GAO/GGD-91-118.

12. GAO, "Costs And Uses Of Third-Party Information Returns," Report to the Committee on Finance, U.S. Senate, GAO-08-266. November 2007, Highlights, accessed at http://www.gao.gov/cgi-bin/getrpt?GAO-08-266.

13. U.S. Department of the Treasury, "General Explanations Of The Administration's Fiscal Year 2010 Revenue Proposals," May 2009, p. 90, accessed at http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf.

14. *Ibid.*, p. 130.

15. Senate Finance Committee, "Baucus Comments On GAO Recommendations To Improve Tax Compliance," News Release, February 27, 2009, accessed at http://finance.senate.gov/press/Bpress/2009press/prb022709.pdf.

16. GAO, "Costs And Uses Of Third-Party Information Returns," pp. 24-25.

17. GAO, "Miscellaneous Income Reporting," p. 1. According to the IRS's estimate, the underpayment was initially $345 billion, but late payments by taxpayers and enforcement actions by the IRS produced $55 billion, leaving a net tax gap of $290 billion.

18. For example, one small business with under 5 employees told GAO that it spends perhaps 3 to 5 hours a year preparing 1099 forms, which sounds plausible if the business submits just a few 1099s and the payments it reports are all easily categorized for tax purposes. See GAO, "Costs And Uses Of Third-Party Information Returns," p. 3.

19. J. Scott Moody, "The Impact of Tax Complexity on Small Businesses," Testimony Before the Subcommittee on Tax, Finance, and Exports of the House Small Business Committee, Tax Foundation, Special Brief, September 2000, accessed at http://www.taxfoundation.org/files/b6c11ee42f3ded790c8e7cebb982125c.pdf.

20. For instance, the person who handles the accounting at one small organization told the author that if the payments-to-corporations exemption were eliminated, the resulting blizzard of information gathering, form preparations, and Form 1099-MISC submissions would be a "nightmare".

21. For some of the mitigation options GAO has noted, see GAO, "Benefits Of A Corporate Document Matching Program Exceed The Costs," pp. 6-7; and GAO, "Costs And Uses Of Third-Party Information Returns," pp. 4, 49-55.

22. Another possibility GAO raised would be to remove the payments-to-corporation exemption in some cases but not others based on the characteristics of the corporations receiving the payments. For example, GAO wrote, businesses of all sizes might have to notify the IRS of payments to corporations that are "privately held or below a certain size." (GAO, "Costs And Uses Of Third-Party Information Returns," p. 50.) Perhaps GAO's logic is that publicly held companies and large companies are already so closely watched by the IRS and their own auditors that they are strongly discouraged from concealing their receipts regardless of whether the IRS receives third-party 1099-MISCs. While that argument has some merit, such an approach fails to shield small businesses with relatively high tax-form-preparation costs from having to submit significantly more 1099-MISCs. Another concern is that Congress and the IRS might not provide clear and simple rules, making it difficult for payers to determine if the corporations to which they make payments are exempt or nonexempt from the reporting requirement. Clear and simple rules would increase the attractiveness of this option, but ambiguous rules would add yet more confusion to an already too complicated tax code.

23. GAO, "Costs And Uses Of Third-Party Information Returns," p. 41.

24. For governments, the threshold might be based on their receipts or their spending in a base year. Suppose it is $5 million, as in the previous example. Because government entities often have large budgets, most would be above the threshold and have to begin filing 1099-MISCs on their payments to corporations for services, but some very small government entities would retain the corporate exemption.