



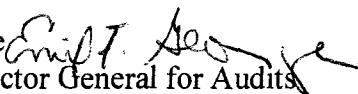
UNITED STATES GOVERNMENT
National Labor Relations Board
Office of Inspector General

Memorandum

March 18, 2008

To: Richard A. Siegel
Associate General Counsel

Karl E. Rohrbaugh
Finance Branch Chief

From: Emil T. George 
Assistant Inspector General for Audits

Subject: Inspection Report No. OIG-INS-52-08-01: Tax Gap

We initiated this inspection in January 2008 to determine whether the National Labor Relations Board's (Agency) reporting to the Internal Revenue Service (IRS) is consistent with applicable requirements and supports proper reporting of taxable income.

The Agency did not prepare Form 1099-MISCs for 19 vendors who provided services of a value that exceeded \$600. The total value of the services that should have been reported for those 19 vendors was \$317,771. Also, the Agency did not prepare a Form 1099-INT for a vendor who was paid \$1,150 in Prompt Payment Act interest. The Finance Branch (Finance) subsequently prepared and sent the appropriate tax forms to the vendors. Additionally, for 28 vendors the amount reported on Form 1099-MISC did not match the payment data in the Agency's financial system. A total of \$24,176 was overreported for 14 vendors and a total of \$83,428 was underreported for 14 vendors. The total underreported payments in calendar year 2007 were \$402,349.

Payments made to backpay recipients by Finance generally matched the instructions received from the Regional Office regarding the amounts and the distribution between backpay, interest, dues, medical expenses, and other non-taxable income. In general, items were properly reported on the appropriate forms.

SCOPE

We reviewed laws and regulations related to the reporting of taxable income to the IRS. We also reviewed the 2007 instructions for preparing IRS Forms W-2, Wage and Tax Statement, 1099-MISC, Miscellaneous Income, and 1099-INT, Interest Income. We reviewed other IRS guidance related to tax reporting, including Revenue Procedure 2004-43, Merchant Category

Codes to Determine Reportable Payment Card Transactions, dated August 2, 2004. We interviewed staff with the IRS' Office of Federal, State and Local Governments to confirm our understanding of the reporting requirements placed on Federal agencies.

We interviewed staff in Finance to identify procedures for reporting vendor payments. We obtained a listing of the budget object classes used by the Agency and compared them to IRS criteria to determine those containing payments reportable to the IRS. We obtained a listing of payments made during calendar year 2007 and compared them to budget object classes and IRS criteria to identify the universe of vendors who received payments that should have been reported. We compared this universe to a listing of Form 1099-MISCs prepared by Finance to determine whether the payments were properly reported to the IRS. We selected a judgmental sample of 10 Form 1099-MISCs that did not agree to amounts in the Agency's financial management system to determine whether systematic reasons existed for the differences.

We interviewed staff in the Division of Operations-Management and Finance in order to identify Agency procedures regarding tax reporting for payments to backpay recipients. We selected a judgmental sample of 10 backpay cases involving 51 discriminatees paid through Finance during calendar year 2007. We compared payment instructions sent by the Regional Offices to Finance with the payments that were actually made and the tax forms that were prepared to report those payments to determine whether the payments were properly reported.

We conducted this review from January through March 2008. This review was done in accordance with the Quality Standards for Inspections issued by the President's Council on Integrity and Efficiency.

BACKGROUND

The Internal Revenue Code (IRC) places three primary obligations on taxpayers: (1) to file timely returns; (2) to make accurate reports on those returns; and (3) to pay the required tax voluntarily and timely. When taxpayers do not meet these obligations, the tax gap results. The tax gap is defined as the aggregate amount of true tax liability, which is the amount of tax that would be determined for the tax year if all relevant aspects of the tax law were correctly applied to all relevant facts of the taxpayer's situation, not paid voluntarily and timely.

The IRS reported that the tax gap was \$290 billion in 2001. The majority of the tax gap is due to underreporting of taxes by individuals. The IRS reported that the percentage of taxpayer income reporting compliance increases as the level of reporting or withholding increases.

RESULTS

Vendor Payments

IRC Section 6041A requires that payments of \$600 or more made by a Federal executive agency in exchange for performance of services be reported on information returns that include the service recipient's taxpayer identification number. The purpose of the requirement in Section 6041A is to identify unreported income. In 1997, this section was amended to require Federal agencies to report payments for services provided by corporations. The legislative history for this change states that it will improve compliance because additional, small-dollar value contracts will be reported. This requirement includes purchase card transactions. IRC Section 6041 requires information reporting by a Federal executive agency for other payments such as rent and interest.

Payments for nonemployee compensation are reported on Form 1099-MISC. Examples include payments for professional service fees, such as fees to attorneys, accountants, architects, and contractors, and payments for services, including payment for parts or materials used to perform services if supplying the parts or materials was incidental to providing the service. Reporting on the Form 1099-MISC is generally not required for payment of bills for merchandise, telephone, freight, storage, and similar charges. Rents are also reported on Form 1099-MISC. Reportable rental payments include those for office space, parking, and equipment. For calendar year 2007, the value of the services reported by the Agency on Form 1099-MISCs to vendors totaled \$11,058,238.

IRS Revenue Procedure 2004-43 provides an optional procedure that payors may use in determining whether purchase card transactions are reportable under section 6041 or section 6041A of the IRC. Under that procedure, the payor may rely on the Merchant Category Code assigned to the merchant/payee in determining whether the merchant is subject to information reporting. However, the revenue procedure also states that if the payor determines that the Merchant Category Code does not reflect the actual nature of the transaction, the payor may determine whether information reporting is required based on the actual nature of the transaction.

Vendors without Form 1099-MISC

We identified 247 vendors who received payments from the Agency in excess of \$600 for which the Agency should have prepared a Form 1099-MISC. Of those, the Agency did not prepare a Form 1099-MISC for 19 vendors for services totaling \$317,771.

Items in Budget Object Class 25

Staff in Finance stated that the universe of reportable vendors is based on payments made to vendors in Budget Object Class 25 – Other Contractual Services. The Agency did not prepare a Form 1099-MISC for two vendors in Budget Object Class 25. One was a vendor who received \$1,438 in payments for interpreter fees. Staff in Finance stated that the vendor is a resident of Puerto Rico and was not subject to Federal income tax. The IRS, however, requires that if a taxpayer has no U.S. filing requirement, but has income that is effectively connected with a trade

or business, the taxpayer must file forms with the IRS to report self-employment income and, if necessary, pay self-employment tax. The instructions for Form 1099-MISC state that generally income placed in box 7 (nonemployee compensation) is subject to self-employment tax. The other vendor was paid \$35,493 for travel agency fees.

Items outside of Budget Object Class 25

We identified 14 budget object classes outside of Budget Object Class 25 that are services and should be reported on a Form 1099-MISC. They include rental for copiers and other equipment, courier services, lodging, and printing services. Within those 14 budget object classes, we identified payments to eight vendors totaling \$243,693 for which the Agency did not prepare a Form 1099-MISC.

Purchase Card Transactions

Nine vendors that had only purchase card transactions that were recorded in Budget Object Class 25, totaling \$37,147, did not receive a Form 1099-MISC. Staff in Finance noted that purchase card transactions are entered into the Agency's financial system on a daily basis and are given a budget object class based on the Merchant Category Code. According to Finance, program offices review transactions and request a correction to the budget object class if it is recorded incorrectly. Payments to these nine vendors had the budget object class changed from one that was not reportable to one that should be reported. Because the Agency determined that those transactions involved services, the Agency should have reported those payments to the IRS.

Accuracy of Form 1099-MISCs

We identified 28 vendors for whom the payment data in the financial system did not match the amount reported on the Form 1099-MISC. A total of \$24,176 was overreported for 14 vendors and a total of \$83,428 was underreported for 14 vendors. For the items that we judgmentally selected for further review, the following issues were found:

- For one vendor, the payments were understated by \$74,903. The majority of the difference was due to the rental payments for machines being excluded.
- For two vendors, purchase card transactions totaling \$4,651 were not included on the Form 1099-MISC that each received. For both vendors, the budget object class of the transaction was changed from one that was not reportable to one that is reportable.
- For two vendors, a purchase card transaction was double-counted in the calculation of the amount to report, resulting in \$4,305 being overreported.
- For one vendor, payments of \$3,209 that were moved to the budget object class for supplies were reported on the Form 1099-MISC, resulting in an overreporting.

Vendors without a Form 1099-INT

Section 1.6041-1 of the IRS regulations states that an information return must be prepared for interest aggregating \$600 or more. During 2007, the Agency paid \$1,150 to one vendor as interest incurred under the Prompt Payment Act. The Agency did not prepare a Form 1099-INT for the payment.

SUGGESTIONS

We suggest that the Finance Chief:

1. Develop procedures to determine which budget object classes contain services.
2. Develop procedures to ensure that all applicable vendors payments categorized in budget object classes for services are reported.