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Report to Designated Congressional Committees

March 1996

TAX POLICY AND ADMINISTRATION

1995 Annual Report on GAO's Tax-Related Work

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The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

The Honorable Ted Stevens
Chairman, Committee on
Governmental Affairs
United States Senate

The Honorable Bill Archer
Chairman, Committee on
Ways and Means
House of Representatives

The Honorable William F. Clinger, Jr.
Chairman, Committee on
Government Reform and Oversight
House of Representatives

This report is submitted in compliance with 31 U.S.C. 719(d) and summarizes our work on tax policy and administration in fiscal year 1995. It contains appendixes that highlight (1) agency actions taken on our recommendations, as of December 31, 1995; (2) recommendations we made to Congress before and during fiscal year 1995 that have not been acted upon; and (3) assignments for which we were authorized access to tax information under 26 U.S.C. 6103(i)(7)(A).

Key Recommendations for Tax Policy and Administration

In our reports and testimonies, we suggested actions that if taken could improve compliance with the tax laws, assist taxpayers, enhance the effectiveness of tax incentives, improve Internal Revenue Service (IRS) management, and improve the processing of returns and receipts. The associated reports and testimonies are summarized in the appendixes. The following pages highlight notable reports and testimonies from fiscal year 1995.

Improve Compliance With Tax Laws

One of IRS' goals is to increase voluntary compliance. We issued several reports and testimonies in fiscal year 1995 dealing with IRS' primary compliance measurement program and IRS' efforts to reduce noncompliance.

Status of Tax Year 1994 Compliance Measurement Program. IRS' Taxpayer Compliance Measurement Program (TCMP) plays an important role in national tax policy and administration decisions. IRS collects TCMP data by doing extensive audits on a random sample of tax returns. IRS uses the sample data to measure compliance levels, estimate the tax gap, develop formulas for selecting returns to audit, identify compliance issues, and allocate its resources. Because of TCMP's importance, we monitored IRS' plans to develop and implement the tax year 1994 TCMP for which audits were slated to begin in October 1995. We concluded that (1) IRS' 1994 TCMP would be the most comprehensive TCMP effort ever undertaken, (2) its larger sample compared with past TCMP efforts would allow for more sophisticated and powerful analyses, (3) new audit techniques and more information should help IRS auditors do higher quality audits, and (4) the many changes and added complexity would increase the importance of adequate training of the auditors and supervisory review of their work. We continue to believe that TCMP is a good investment because it is IRS' tool for objectively measuring compliance with tax laws. The 1994 TCMP was delayed indefinitely, however, because of congressional concerns about both the cost and taxpayer burden associated with the TCMP and budget cuts. IRS is considering several alternatives, but as of December 31, 1995, no alternative had been selected (GAO/GGD-95-39, Dec. 30, 1994; GAO/T-GGD-95-207, July 18, 1995). (See p. 20.)

Reducing the Income Tax Gap. One of the greatest challenges facing IRS is finding ways to reduce the gross income tax gap—the difference between income taxes owed and those voluntarily paid. IRS estimates that more than $100 billion in income from legal sources is at stake annually. IRS attributes about three-fourths of the tax gap to individuals and about one-fourth to corporations. To explore innovative and practical ways to reduce the tax gap, we sponsored a symposium on January 12, 1995, that brought together well-known tax authorities with congressional, IRS, and our staff. In general, the panelists identified several objectives that, if met, could help improve compliance: (1) reduce tax law ambiguity and complexity; (2) extend the reach of tax requirements, such as income tax withholding, that tend to promote taxpayer compliance; (3) expand compliance techniques such as information sharing with states and enhanced penalties; (4) more aggressively focus on unreported income; (5) improve IRS' compliance data; and (6) improve IRS' ability to resolve compliance problems quickly. The panelists also cautioned against excessive intrusions into taxpayers' affairs, which could defeat IRS' objectives. In June 1995, we testified that (1) compliance varies across groups of taxpayers and is lowest where there is neither withholding nor information reporting and (2) some of the tax gap may not be collectible at an acceptable cost, making it important that IRS measure compliance and use that information to effectively focus its resources. In a December 1994 report, we discussed the tax gap for one group of taxpayers—self-employed persons who provide services (GAO/GGD-95-59, Dec. 28, 1994; GAO/GGD-95-157, June 2, 1995; GAO/T-GGD-95-176, June 6, 1995). (See pp. 19, 26, and 27.)

Tax Compliance Burden Facing Business Taxpayers. As business taxpayers strive to comply with federal, state, and local tax requirements, they expend time, incur costs, and experience frustrations. We define this effort as "taxpayer compliance burden." Using available studies on federal compliance burden, supplemented with interviews of business taxpayers, we found that the complexity of the Internal Revenue Code, compounded by the frequent changes made to the code, is the source of most business taxpayer burden. Determining a reliable estimate of the cost of such burden would be costly and in itself burdensome on businesses. In testimony, we provided examples of code provisions and of IRS' administration of the code that are most problematic to business. We also provided some of the businesses' suggestions for simplification (GAO/T-GGD-95-42, Dec. 9, 1994). (See p. 18.)

Pricing of Intercompany Transactions (Transfer Pricing). Transfer pricing affects the distribution of profits and therefore taxable income among related companies and sometimes across tax jurisdictions. Abusive transfer pricing occurs when income and expenses are improperly allocated among related companies to reduce certain companies' taxable income. Section 482 of the Internal Revenue Code allows IRS to reallocate income among related parties if it finds violations. In an April 1995 report, we (1) provided information on IRS' recent experiences in dealing with transfer pricing issues and its use of available regulatory and procedural tools and (2) updated earlier analyses showing how many U.S.-controlled corporations and foreign-controlled corporations paid no U.S. income tax. In 1993 and 1994, IRS examiners found, as they had in previous years, many section 482 violations. Also, as in past years, IRS sustained less than 30 percent of the proposed adjustments. According to IRS officials, certain procedural tools, such as measures to obtain information and stronger penalties, had served mostly as deterrents. It was too soon to assess the success of transfer pricing regulations issued in July 1994 (GAO/GGD-95-101, Apr. 13, 1995). (See p. 22.)

California's Experiences in Taxing Multinational Corporations. A worldwide formulary apportionment system has been proposed by some state tax officials and other tax experts as an alternative to the existing tax system. In a July 1995 report, we discussed the issues to be considered before a federal formulary apportionment could be adopted. Also, we discussed California's experience with its own version of the advocated federal system in which multinational enterprises apportion a share of their worldwide income to California. The California formulary approach can be applied to income from a single corporation or from a group of affiliated corporations (GAO/GGD-95-171, July 11, 1995). (See p. 30.)

Assist Taxpayers

To ease taxpayer frustration and increase the likelihood of voluntary compliance with the tax laws, IRS must (1) treat taxpayers fairly, (2) provide timely and accurate assistance, and (3) communicate clearly. Several of our fiscal year 1995 products dealt with those issues.

Treating Taxpayers Fairly. Several initiatives have been undertaken in recent years to better protect taxpayers, including enactment of the Taxpayer Bill of Rights in 1988 and internal IRS efforts to treat taxpayers as customers and to improve its operations. IRS has a wide range of controls, processes, and oversight offices to govern the behavior of its employees in dealing with taxpayers. Despite the many controls intended to protect taxpayers, we found examples that fell within our definition of taxpayer abuse. We concluded that IRS needs to specifically define taxpayer abuse and develop management information about it to identify and rectify future instances of abuse. We recommended that IRS strengthen its controls in several areas and provide additional information to taxpayers that will increase their ability to protect their rights. Such steps would enable IRS and Congress to better evaluate IRS' performance in protecting taxpayers' rights (GAO/GGD-95-14, Oct. 26, 1994). (See p. 34.)

Telephone Assistance. Many taxpayers who seek help through IRS' telephone assistance program are not getting it. Even with increased productivity, IRS has not kept pace with the significant growth in the number of calls received. IRS employees answered about one out of two calls in fiscal year 1989 but only one out of four calls in fiscal year 1994. Even with new technology, IRS has been unable to provide the level of telephone service provided by the Social Security Administration (SSA) and four private sector companies we contacted. We recommended that IRS improve its technology to include real-time call traffic monitoring and management, using the routing capability of its telecommunications vendor and fully implementing the features of call routing technology already available (GAO/GGD-95-86, Apr. 12, 1995). (See p. 41.)

Improving IRS Notices. Each year IRS sends millions of notices to taxpayers concerning the status of their tax accounts. We reviewed 47 of the most commonly used notices and identified clarity concerns with 31 of them. We also found that IRS' ability to improve its notices is adversely affected by limited computer programming resources and higher priority programming requests. Further, the lack of a system to track the progress of proposed notice language changes limits IRS' ability to oversee notice clarity improvements. We recommended changes to its current notice generation process and a new system to monitor proposed notice text revisions (GAO/GGD-95-6, Dec. 7, 1994). (See p. 37.)

Improving Forms and Publications. Providing taxpayers with easy-to-read tax forms and publications is a difficult task for several reasons. The tax code is frequently revised, consequently many publications must also be revised annually under short time constraints. In addition, taxpayers' comprehension levels vary. Generally, we found IRS' process for developing and revising tax forms and publications reasonable. IRS maintains a dialogue with tax professionals and attempts to generate as much feedback as possible from taxpayers. We recommended that IRS take additional steps to identify the specific concerns of individual taxpayers. Specifically, gathering information on the nature of taxpayer questions through its toll-free telephone system and making greater use of IRS field personnel who have more contact with taxpayers should generate additional useful feedback to IRS (GAO/GGD-95-34, Dec. 7, 1994). (See p. 39.)

Enhance Effectiveness of Tax Incentives

Congress continues to seek equitable ways to reform the current tax system. At the same time, it adopts tax incentives and preferences to promote certain social policy goals. The result is often foregone revenues to the federal treasury. In response to congressional requests, we provided information on two such incentives, the Earned Income Credit (EIC) and the research tax credit.

Earned Income Credit. The EIC is a major federal effort to assist the working poor. Established in 1975, Congress intended that the EIC (1) offset the impact of Social Security taxes on low-income workers and (2) encourage low-income individuals to seek employment rather than welfare. Congress and IRS have long been concerned about EIC noncompliance. In 1988, according to IRS, about 42 percent of the EIC recipients received too large a credit and about 34 percent of total EIC paid out may have been awarded erroneously. Limited studies since then by IRS suggest that noncompliance is still a problem. Further, some EIC recipients are illegal aliens who may receive the EIC if they meet the credit's eligibility rules. Awarding the EIC to illegal aliens, however, works at cross-purposes with federal policies that prohibit illegal aliens from legally working in the United States. An IRS analysis of some tax returns filed in 1993 provided enough information to convince IRS officials that about 160,000 EIC recipients probably were illegal aliens at that time. To better target the EIC to the working poor, IRS needs to change some of the definitions used to determine eligibility and develop better measures of EIC filers' resources to determine their eligibility (GAO/GGD-95-27, Oct. 25, 1994; GAO/GGD-95-122BR, Mar. 31, 1995; GAO/T-GGD-95-136, Apr. 4, 1995; GAO/T-GGD-95-179, June 8, 1995). (See p. 45.)

Benefits from the Research Tax Credit. In 1981, Congress created the research tax credit to enhance the competitive position of the United States in the world economy by encouraging the business community to do more research. The credit has been extended six times and modified four times since its inception. It expired in June 1995. Legislation to extend the credit was introduced but had not been enacted as of December 31, 1995. We took no position on whether the research credit should be made a permanent part of the tax code or allowed to expire given the lack of empirical data for evaluating the credit's net benefit to society. We said that the credit's net benefit to society would ideally be evaluated in terms of the ultimate benefits derived from the additional research that it stimulated and not just on the basis of how much research spending it stimulates for a given revenue cost. We suggested that Congress review the base of the credit periodically and adjust it as needed because the credit can become too generous or too restrictive over time. We presented evidence from corporate tax returns indicating that the accuracy of the credit's base had eroded significantly since 1989 (GAO/T-GGD-95-140, Apr. 3, 1995; GAO/T-GGD-95-161, May 10, 1995). (See p. 46.)

Improve IRS Management

Although IRS has implemented many changes we recommended, pervasive management problems remain. These management problems are further complicated by aging information systems in a period of declining federal budgets.

Management of Tax Systems Modernization (TSM) Program. In testimony and a companion report to the Commissioner of Internal

Revenue, we discussed IRS' progress in implementing its $8 billion modernization program and described serious management and technical weaknesses that must be corrected if TSM is to succeed. We made numerous recommendations for improving IRS' business management and information systems management and development capabilities so that TSM is better focused to meet IRS' mission needs. IRS has several efforts under way to deal with our concerns and has developed an action plan for implementing our recommendations (GAO/T-AIMD-95-86, Feb. 16, 1995; GAO/AIMD-95-156, July 26, 1995). (See p. 51.)

IRS' Fiscal Year 1994 Financial Statements. In accordance with the Chief Financial Officer Act of 1990, we reported the results of our efforts to audit IRS' Principal Financial Statements for the fiscal year ending September 30, 1994. The report included an assessment of IRS' internal controls and its compliance with laws and regulations. As in prior years, we were unable to express an opinion on the reliability of the financial statements. Our report discussed the scope and severity of financial management and control problems and IRS' actions to remedy them and updated the status of recommendations from our audits of fiscal years 1992 and 1993. Overcoming these problems will be difficult because of the long-standing nature and depth of IRS' financial management problems and the antiquated state of its information systems (GAO/AIMD-95-141, Aug. 4, 1995). (See p. 54.)

IRS Receivables—A High-Risk Area. We issued a series of reports on federal program areas considered to be high risk because they are especially vulnerable to waste, fraud, abuse, and mismanagement. This report discussed one such area, IRS' management of its accounts receivable. IRS' failure to resolve nearly $156 billion in outstanding tax delinquencies has not only lessened the revenues immediately available to support government operations but could also jeopardize future taxpayer compliance by giving the impression that IRS is neither fair nor serious about collecting overdue taxes. In spite of several initiatives to solve this problem, IRS has been unable to significantly improve the accuracy of its delinquent accounts inventory, slow the growth in accounts receivable, or accelerate and increase the collection of overdue taxes. IRS still lacks needed information to guide collection efforts, its collection process is outdated and inefficient, and its decentralized organizational structure makes dealing with problems that cut across the agency difficult (GAO/HR-95-6, Feb. 1995). (See p. 49.)

Improve the Processing of Returns and Receipts

IRS' most basic function is to receive and process tax returns and tax payments. We issued several reports relating to those activities in fiscal year 1995, including the two discussed below.

Improving IRS' Installment Agreement Program. Since 1991, taxpayer use of installment agreements has grown considerably, and such agreements have accounted for a growing portion of IRS' collection activity. Much of the growth occurred after April 1992 when IRS streamlined the installment agreement approval process. IRS internal auditors reported that some taxpayers were using installment agreements when they were able to fully pay taxes. This practice conflicts with IRS' intent to encourage installment agreements for taxpayers who cannot otherwise pay their taxes in full when they are due. In addition, the auditors were concerned about the ease with which taxpayers could accumulate additional tax debt by adding new income tax liabilities to existing installment agreements. We raised concerns about certain administrative aspects of the program and recommended changes whereby IRS would (1) provide taxpayers more information about the terms, conditions, and costs of installment agreements and (2) experiment with several methods for reducing installment agreement servicing costs (GAO/GGD-95-137, May 2, 1995). (See p. 60.)

Verifying Taxpayer Identities. This report discussed IRS' procedures for processing and posting tax returns in which the primary filer does not provide a Social Security Number (SSN) or provides a name and SSN that do not match SSA records. Returns that can be corrected along with those that match SSA records are posted to the "valid segment" of the Individual Master File (IMF) while those that cannot be corrected are posted to the "invalid segment" of the IMF. From 1986 through 1994, the average annual growth rate of accounts on the invalid segment of the IMF was more than twice the growth rate for accounts on the valid segment. IRS paid $1.4 billion in refunds on returns that were posted to the invalid segment of the IMF for tax year 1993. No one knows how much, if any, of this amount was erroneously paid; however, the risk of error was higher because IRS was less certain of these filers' identities. We recommended ways IRS could improve the processing of returns with missing or incorrect SSNs and clean up IMF accounts which could adversely affect IRS' tax modernization plans (GAO/GGD-95-148, Aug. 30, 1995). (See p. 56.)

We did our work on tax policy and administration matters pursuant to 31 U.S.C. 713, which authorizes the Comptroller General to audit IRS and the Bureau of Alcohol, Tobacco, and Firearms. GAO Order 0135.1, as amended, prescribes the procedures and requirements that must be followed in protecting the confidentiality of tax returns and return information made available to us when doing tax-related work. This order is available upon request.

Copies of this report are being sent to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Commissioner of Internal Revenue. Copies will be sent to interested congressional committees and to others upon request.

Major contributors to this report are listed in appendix VII. If you or your colleagues would like to discuss any of the matters in this report, please call me on (202) 512-9110.

Lynda D Willis

Lynda D. Willis
Director, Tax Policy and
Administration Issues

Contents

Abbreviations

AFDC	Aid to Families With Dependent Children
AMT	Alternative Minimum Tax
BMF	Business Master File
CMM	Capability Maturity Model
CREF	Cross-Reference Entity File
EIC	Earned Income Credit
EIN	Employer Identification Number
ELF	Electronic Filing
ETEP	Employment Tax Examination Program
FICA	Federal Insurance Contribution Act
FMFIA	Federal Managers' Financial Integrity Act
FCC	Foreign-controlled corporation
IMF	Individual Master File
IRS	Internal Revenue Service
LIHTC	Low Income Housing Tax Credit
NTEU	National Treasury Employees Union
OMB	Office of Management and Budget
SSA	Social Security Administration
SSN	Social Security Number
TCMP	Taxpayer Compliance Measurement Program
TSM	Tax Systems Modernization
TSP	Thrift Savings Plan
USCC	U.S.-controlled corporation

Summaries of Tax-Related Products Issued in Fiscal Year 1995 by Subject Matter

Improve Compliance With Tax Laws

Tax Compliance Burden Faced by Business Taxpayers

GAO/T-GGD-95-42, 12/09/94

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, we observed that as business taxpayers strive to comply with federal, state, and local tax requirements they expend time, incur costs, and experience frustrations. We refer to this time, cost, and frustration collectively as "taxpayer compliance burden." We were asked by the Ranking Minority Member to identify the sources of the burden and determine the reliability of taxpayer burden cost estimates appearing in compliance cost and tax simplification literature.

We collected information on compliance burden from the management and tax staffs of selected businesses, tax accountants, tax lawyers, representatives of tax associations, and IRS officials. Additionally, we reviewed academic research and other studies on compliance burden and tax simplification. The focus of our efforts was the federal tax system.

We testified that (1) according to those business officials interviewed, the complexity of the Internal Revenue Code was the driving force behind federal tax compliance burden; (2) a reliable estimate of the overall costs of tax compliance was not available and would be costly and burdensome on businesses to obtain; (3) reducing compliance burden would be a difficult undertaking because of the various policy trade-offs, such as revenue and taxpayer equity, that must be made; and (4) while business officials and tax experts acknowledged the legitimate purposes of the federal tax system, they believed that several code provisions are problematic and need simplification.

While we were unable to identify reliable tax burden cost estimates, there was consensus among the business respondents, tax experts, and the literature that tax compliance burden is significant and that it can be reduced. Although some gains can be made by reducing administrative burden imposed by IRS, the greatest potential for reducing taxpayer compliance burden is by dealing with the complexity of the tax code. One approach to reducing burden would be to tackle particularly burdensome provisions individually. Provisions identified as especially burdensome include Alternative Minimum Tax (AMT), uniform capitalization, pension and payroll provisions, and the foreign tax credit. We believe that simplification of any of these provisions has the potential for reducing the tax burden of many businesses.

Related GAO Product(s)

GAO/GGD-95-6, 12/07/94; GAO/GGD-95-34, 12/07/94; GAO/T-AIMD/GGD-95-80, 02/07/95; and GAO/GGD-95-88, 04/03/95

Estimates of the Tax Gap for Service Providers

GAO/GGD-95-59, 12/28/94

In a report to the Chairman of the Joint Committee on Taxation, we provided information about the tax gap for sole proprietors, i.e., self-employed individuals. We presented estimates of the tax year 1992 gross income tax gap for nonfarm sole proprietors who provided services and estimates of the tax gap attributable to service providers who may have been employees rather than self-employed. The gross income tax gap is the difference between the amount of income taxes owed and the amount voluntarily paid. Tax-gap estimates are important because they can be used to measure IRS' progress in confronting noncompliance and to help IRS allocate its compliance resources.

We estimated that between 9.2 million and 11.5 million of the 13 million nonfarm sole proprietors might be considered service providers. IRS estimated that the 1992 tax gap among these service providers ranged from $21 billion to $30.3 billion—that is, from 56 to 81 percent of IRS' estimated tax gap of $37.2 billion for all nonfarm sole proprietors who filed a return.

We estimated that between 0.2 million and 1.6 million of the 11.5 million service providers may be misclassified as service providers by their employers. IRS estimated that between $2 billion and $3.5 billion of the $30.3 billion tax gap was associated with these potentially misclassified workers. This tax gap estimate included only service providers who received all their self-employment income from one business. The $2 billion estimate included only those receiving $20,000 or more in income from one business. The $3.5 billion estimate included all such service providers regardless of the amount. We believe that if these workers had been classified correctly as employees, a significant amount of the taxes owed would likely have been withheld by their employer.

Related GAO Product(s)

GAO/GGD-92-108, 07/23/92; GAO/GGD-94-123, 05/11/94; GAO/GGD-94-175, 08/02/94; GAO/GGD-95-157, 06/02/95; GAO/T-GGD-95-176, 06/06/95; and GAO/T-GGD-95-224, 08/02/95

Status of the Tax Year 1994 Compliance Measurement Program

GAO/GGD-95-39, 12/30/94 and GAO/T-GGD-95-207, 07/18/95

In a report to the Joint Committee on Taxation and in subsequent testimony before the Subcommittee on Oversight, House Committee on Way and Means, we commented on the status of IRS' planning efforts for the 1994 Taxpayer Compliance Measurement Program (TCMP). We analyzed IRS' available plans and commented on potential strengths and weaknesses of the program.

We said that the 1994 TCMP survey may have been the most comprehensive TCMP effort ever undertaken. Planned to include over 150,000 tax returns, it was designed to obtain compliance information for individuals, small corporations, partnerships, and S corporations—further disaggregated into 24 types of businesses and 3 types of individual taxpayers. IRS planned for most sample results to be usable at the national level as well as at smaller geographic areas across the country.

IRS planned to implement several changes from past TCMP surveys. IRS planned to have auditors use computers to capture audit adjustments. For each adjustment, IRS planned to (1) instruct auditors to determine the tax issue involved and the reason for the taxpayer error; (2) provide auditors with tax return data for 1994 and the prior 2 years as well as other tax information on each taxpayer; and (3) help uncover erroneous tax-return information using an “economic reality” audit technique, which surveys the taxpayer’s lifestyle relative to the information reported on the tax return. We supported these planned changes and said that they offered promise for improving the value of TCMP results.

We also expressed some concerns about the 1994 TCMP. We were concerned that IRS might not meet scheduled milestones so that TCMP audits could begin as planned in October 1995 and that IRS’ plans had some missing pieces. We reported that IRS was working to address these concerns:

- No research plan that specifically defined the research questions to be answered and how the data to be collected would be used to answer the questions.
- No plans to collect information on all income and deduction items for partnership and S corporation returns or plans to determine the tax impact of changes to these returns.
- No plans to collect information on potentially misclassified workers.
- No plans to collect information on other known compliance issues such as those dealing with the earned income credit and wage reporting.
- No plans for developing a mechanism that would electronically retrieve TCMP audit workpapers for IRS and other researchers.

We raised these concerns so that IRS could consider them and make necessary changes in an informed manner rather than waiting until the last minute. We favored this approach so that IRS, as well as others, had more confidence that the TCMP audits would not only start in October 1995 but also produce more useful data.

Action(s) Taken And/or Pending

IRS took appropriate action on the concerns we raised in this report and testimony that dealt with meeting milestones for starting TCMP audits and collecting and analyzing data. However, the 1995 TCMP has been delayed indefinitely because of congressional concerns about the cost of TCMP, its burden on taxpayers, and budget cuts. IRS is considering several alternatives, but as of December 31, 1995, no firm alternative had been selected.

Related GAO Product(s)

GAO/GGD-93-60, 03/19/93; GAO/GGD-93-52, 04/05/93; GAO/GGD-94-123, 05/11/94; GAO/GGD-95-157, 06/02/95; GAO/GGD-95-151, 06/16/95; GAO/T-GGD-95-207, 07/18/95; GAO/GGD-95-199R, 07/19/95; and GAO/GGD-96-21, 10/06/95

Tax Compliance Initiatives and Delinquent Taxes

GAO/T-GGD-95-74, 02/01/95

In testimony before the Subcommittee on Treasury, Postal Service, and General Government, House Committee on Appropriations, we noted that IRS faces some formidable enforcement challenges, such as closing a tax gap that was last estimated at $127 billion in tax year 1992 and collecting tens of billions of dollars in tax debt. Past Congresses recognized the need to expand IRS' enforcement presence by funding compliance initiatives that would add staff with the intent of increasing compliance and producing more revenue. IRS had not fully implemented past compliance initiatives partly because of circumstances, such as underfunded pay raises, beyond its control. As a result, although the intent of the various initiatives was to increase IRS' enforcement presence, staffing levels in three of IRS' major enforcement programs actually declined between 1989 and 1994.

We testified that some of the additional compliance staffing for 1995 was to be used to collect delinquent tax debts. However, increased staffing is not the only answer to IRS' accounts receivable problem. IRS' problems in this area are more fundamental. First, IRS must improve the accuracy of its delinquent accounts inventory. Second, it needs to slow the growth of the inventory of tax debt. Finally, it needs to accelerate and increase the collection of overdue taxes. Since 1990, IRS has undertaken many efforts toward these objectives; however, it has not made much headway.

We identified five underlying causes that tend to perpetuate IRS' accounts receivable problems: (1) a lack of accurate and reliable information, (2) an outdated and inefficient collection process, (3) difficulty in balancing collection efforts with taxpayer protections, (4) a decentralized organizational structure, and (5) uneven staffing. IRS needs to demonstrate that its efforts will effectively deal with these causes—causes that cut across the agency and across lines of managerial authority and responsibility. IRS also needs to reengineer its outdated collection process and take greater advantage of private sector practices.

Related GAO Product(s)

GAO/GGD-92-45FS, 01/30/92; GAO/GGD-92-118, 07/31/92; GAO/T-GGD-93-23, 04/28/93; GAO/GGD-94-129, 04/20/94; and GAO/HR-95-6, 02/95

Transfer Pricing and Information on Nonpayment of Tax

GAO/GGD-95-101, 04/13/95

In a report to Senator Byron L. Dorgan and Congressman Paul E. Kanjorski, we updated our 1993 work and provided recent data on transfer pricing issues and on tax compliance of foreign-controlled corporations (FCC) and U.S.-controlled corporations (USCC). Transfer pricing is governed by section 482 of the Internal Revenue Code.

IRS' recent experiences with examinations, appeals, and litigation relating to section 482 issues were mixed. For instance, in 1993 and 1994, IRS examiners found, as they had in previous years, large section 482 violations. The outcomes of the appeals and legal processes in 1993 and 1994 were similar to those in 1987 and 1988, with IRS sustaining less than 30 percent of the proposed section 482 adjustment amounts. In 1993 and the first part of 1994, IRS had somewhat better success litigating large transfer pricing cases than in 1990 through 1992.

According to IRS officials, certain enforcement tools available to IRS in transfer pricing situations, such as measures to obtain information and stronger penalties, served mostly as deterrents that altered taxpayer behavior. Alternatives to traditional examinations, appeals, and litigation, such as simultaneous examinations, arbitration, and advance pricing agreements, were used infrequently or were expected to grow in number in the future.

How successful the new transfer pricing regulatory regime will be remains to be seen. The flexibility that new regulations allow taxpayers in applying the arm's length standard must be weighed against the flexibility given IRS and the increased documentation required of taxpayers under threat of penalty.

A majority of all FCCs and USCCs paid no U.S. income tax in each year from 1987 through 1991, and the percentages of each—nearly three-quarters of

FCCs and about 60 percent of USCCs—remained largely unchanged over the 5-year period. Although taxpaying corporations were a minority of all FCCs and USCCs, they owned the majority of corporate assets and generated most of the receipts. Furthermore, the largest nontaxpaying corporations—those with assets of $100 million or more—were relatively few in number but accounted for relatively large proportions of all FCCs' and all USCCs' total assets and receipts.

Related GAO Product(s)

GAO/GGD-92-89, 06/15/92; GAO/T-GGD-93-16, 03/25/93; GAO/GGD-93-112FS, 06/11/93; and GAO/GGD-95-171, 07/11/95

Options Reporting to IRS

GAO/GGD-95-145R, 05/05/95

In a letter to Representative Bob Franks, we provided information about reporting options transactions to IRS. (An option is a contract that gives the purchaser the right, in exchange for a premium, to buy or sell a specific amount of a property at an agreed upon price by a specified date.) The member wanted to know why information returns are not filed on options and how information reporting could work.

The Secretary of the Treasury, under section 6045 of the Internal Revenue Code, has broad authority to subject investment payments to information reporting. Using this authority, the Secretary has required information reporting on transactions such as securities and commodities; however, this information reporting excludes options. IRS officials said the exclusion arose from both the complexity of options transactions and from the high administrative burden associated with reporting and using such information.

In 1990, IRS Chief Counsel started a project to establish regulations for information reporting on options, but reporting barriers and lack of compliance data slowed the project. The project is now inactive. Industry representatives told us of similar complexities in reporting options transactions. Most brokers, however, are required by federal regulators and industry associations to annually report options transactions to clients.

IRS attempts to identify unreported income from options trading. It computer matches data received from existing information returns with tax returns to identify discrepancies. IRS officials have not determined the cost-effectiveness of a more elaborate system for reporting and computer-matching options data. Another issue involves the exemption in section 6045 of the Internal Revenue Code granted corporate, financial, and other institutions. An industry official estimated that over half of its options transactions involved institutions instead of individuals.

Before requiring information reporting for options, IRS officials believe IRS needs to determine (1) whether a compliance problem exists and (2) how the obstacles discussed above can be resolved.

Related GAO Product(s)

GAO/GGD-91-118, 09/27/91

Money Laundering: Improvements Needed in Reporting Suspicious Transactions

GAO/GGD-95-156, 05/30/95

Money laundering involves disguising or concealing illicit income to make it appear legitimate. Banks, savings and loans, and credit unions are in a unique position to help identify money launderers by reporting suspicious transactions to law enforcement officials. Financial institutions report tens of thousands of suspicious transactions each year, which have led to many investigations of criminal activities. Because there is no overall control or coordination of these reports, there is no way to ensure that the information is used to its full potential.

Financial institutions report suspicious transactions on various forms that provide different types of information and that are filed with different law enforcement and regulatory agencies. While the form that is filed most frequently with the IRS is contained in a centralized database, it does not contain any additional information describing the suspicious activity that would be useful as an intelligence source for initiating an investigation. Other forms used to report suspicious transactions, which describe the activity so that the information can be evaluated, are not contained in a centralized database but are filed with six different federal financial regulatory agencies, with copies forwarded to the local IRS district office. The use of these forms has varied among IRS' 35 districts. At the time of our audit, there were no IRS procedures or policies as to how information contained in these suspicious transaction reports should be managed as an intelligence resource. Thus, IRS did not know how many reports had been received nationwide, and IRS could not assess the management of the reports from an agencywide perspective.

The Department of the Treasury, the financial regulatory agencies, and IRS have agreed to substantial changes in how suspicious transactions are to be reported and how the information is to be used. Because of the steps they have taken, we did not make recommendations.

Action(s) Taken and/or Pending

IRS is developing new national guidelines that are to mandate consistent evaluation and processing of all reports of suspicious currency transactions. Changes are being made to a management information system to better ensure the proper use of these reports and to track accomplishments.

Related GAO Product(s)

GAO/GGD-93-1, 10/15/92 and GAO/T-GGD-93-31, 05/26/93

Reducing the Tax Gap: Results of a GAO-Sponsored Symposium

GAO/GGD-95-157, 06/02/95

Available IRS data indicate that taxpayers do not pay (either voluntarily or after IRS compliance efforts) about 13 percent of the federal income taxes due on their income from legal sources. Such an estimated shortfall in tax revenue has been a long-standing and seemingly intractable problem.

To explore innovative and practical means for increasing taxpayer compliance, we sought the views of experts in the field. On January 12, 1995, we sponsored a symposium that brought together well-known tax authorities with congressional, IRS, and our staff. The starting point for discussions was our May 1994 overview report, which highlighted the changes that IRS and Congress needed to consider, given the body of work we had already completed.[1]

The panelists concluded that major modifications in the current tax system would be required to substantially improve taxpayer compliance with the nation's tax laws. They identified a number of objectives that, if met, could help to bring about such change: (1) reduce tax law complexity and make results more certain; (2) extend the reach of tax requirements, such as income tax withholding, that promote taxpayer compliance; (3) expand the compliance techniques available to IRS; (4) adjust the focus of IRS' compliance efforts to address more aggressively the largest aspect of noncompliance, i.e., unreported income; (5) improve the utility of IRS'

[1]See Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994).

compliance data; and (6) improve IRS' ability to resolve taxpayer compliance problems quickly, before the problems become serious.

But, as the panelists recognized, any change that extends the reach of the tax system also increases the extent to which the tax system intrudes into taxpayers' affairs and needs to be carefully considered. Thus, the bottom-line decision on whether to extend the reach of the tax system to recover additional revenues due the government under current law involves determining the right mix between (1) the acceptable level of compliance for each type of taxpayer and (2) the acceptable level of tax system intrusiveness to promote compliance within each category of taxpayer.

Related GAO Product(s)

GAO/GGD-94-123, 05/11/94; GAO/GGD-95-59, 12/28/94; and GAO/T-GGD-95-176, 06/06/95

Reducing the Income Tax Gap

GAO/T-GGD-95-176, 06/06/95

One of the biggest challenges facing IRS is finding ways to reduce the gross income tax gap—the difference between income taxes owed and those voluntarily paid. IRS has estimated that taxpayers do not voluntarily pay more than $100 billion annually in taxes due on income from legal sources. While such a tax-gap estimate is necessarily imprecise, it does indicate the size of the challenge confronting tax administration.

In testimony before the House Committee on Ways and Means, we made the following points on meeting this challenge:

- IRS information suggests that U.S. taxpayers voluntarily pay 83 percent of the income taxes they owe. Although this compliance level may be relatively high by world standards, it translates into large sums of tax-gap dollars because of the size of our economy.
- Compliance is not uniform across groups of taxpayers. IRS estimates that wage earners report 97 percent of their wages; the self-employed report 36 percent of their income; and "informal suppliers"—self-employed individuals who operate on a cash basis—report just 11 percent of theirs.
- The IRS data show that compliance is highest where there is tax withholding, a little lower where there is information reporting to IRS, and much lower where there is neither. In addition to the relative visibility of the income to tax administrators, the complexity of tax rules, together with a number of other factors, also influence the level of tax compliance.

- Some of the tax gap may not be collectible at an acceptable cost. Collection, in some instances, could require either more recordkeeping or reporting than the public may be willing to accept or too costly an effort for IRS.

Thus, it is important that IRS invest agency resources to measure noncompliance and use that information to balance efforts among the competing goals of (1) maximizing tax revenues, (2) promoting uniform compliance, and (3) minimizing taxpayer burden.

Related GAO Product(s)

GAO/GGD-94-123, 05/11/94; GAO/GGD-95-59, 12/28/94; and GAO/GGD-95-157, 06/02/95

IRS' Partnership Compliance Activities Could Be Improved

GAO/GGD-95-151, 06/16/95

In a report to the Joint Committee on Taxation, we reviewed IRS' strategy for addressing partnership compliance. IRS' most current partnership compliance data were collected under its tax year 1982 partnership TCMP. These data showed that partnerships underreported their net income by $13 billion in 1982, which we estimated resulted in an underpayment of taxes by partners approaching $3.6 billion. Even when partnerships reported all their income, partners sometimes failed to include it in their own tax returns. Thus, IRS estimated that individual partners owed an additional $2.4 billion in taxes in 1982. Significant tax law changes in the intervening years make these data unreliable indicators of the present situation.

IRS' strategy for addressing partnership compliance relied almost exclusively on audits to detect noncompliance. The strategy did not include either a nonfiler or computer document-matching component. IRS, however, had a limited document-matching program to identify partners who do not report partnership income on their individual income tax returns.

We made several observations concerning IRS' partnership audit program:

- In recent years, relatively few partnership returns were audited because IRS focused its business audit resources on taxable entities such as corporations.
- Partnership audits were not as productive as other types of business returns when measured by the percent of returns audited that resulted in audit adjustments. This may be because the formula used to select

partnership returns for audit was developed from 1982 TCMP data, while the formula used to select corporations for audit was developed from 1987 TCMP data.

- IRS' primary measure of audit productivity—the amount of net taxes assessed per hour of audit time—could not be used for partnership audits because IRS did not have data on the additional taxes partners were assessed or refunded as a result of partnership audit adjustments.
- IRS could analyze current partnership audit results for leads to the types of partnership returns that are more likely to be adjusted during audits.
- IRS did not have an active program to detect partnerships that stopped filing required returns, having discontinued this program in 1989 to concentrate its nonfiler efforts on taxable business returns and employment tax returns.
- In its 1991 individual document-matching program, IRS processed about 12 percent of the Schedules K-1 it received and matched them against partners' income tax returns. The match resulted in additional tax assessments of $6.3 million. We estimated that at an additional cost of $18.6 million to IRS, about $219.5 million in additional taxes may have been assessed if IRS had matched all the schedules.

Recommendation(s) to IRS

We recommended that as IRS moves forward with its modernization efforts, the Commissioner of Internal Revenue

- develop plans to modify audit management information systems to more fully reflect the results of partnership audits by including information on the (1) tax assessments on partners' income tax returns and (2) changes in allocations of profits and losses among partners,
- analyze computer partnership files to develop audit leads and select returns for audit,
- reinstitute the delinquency check program for partnerships to identify partnerships that do not file required tax returns,
- develop plans for a document-matching program using information returns to verify partnership income, and
- devise ways to enter all Schedules K-1 onto the computer so they can be used in the individual computer document-matching program and for other compliance purposes.

Action(s) Taken and/ or Pending

IRS officials generally agreed with our recommendations and are taking actions that we believe will be responsive to them. Specifically, IRS

- is to address the need for expanded data on partnerships and partners in its plans to modernize information systems,
- has begun using partnership computer files to develop leads and select returns for audit through its newly created District Office Research and Analysis sites,
- is to reinstate the partnership delinquency check program for tax year 1994 in calendar year 1996,
- is to test the feasibility of a document-matching program for certain partnerships, and
- is to attempt to more fully utilize available Schedules K-1 data.

Related GAO Product(s)

GAO/GGD-95-39, 12/30/94

California Taxes on Multinational Corporations and Related Federal Issues

GAO/GGD-95-171, 07/11/95

In a report to Senator Byron L. Dorgan, we provided information on (1) California's experience in doing formulary apportionment audits of multinational corporations and (2) issues that would have to be considered before adopting a formulary system at the federal level.

For tax purposes, states generally can use a formula to apportion the income of corporations among the states in which they do business. Through much of the 1980s, California applied its formula for apportioning income on a worldwide basis. This required multinational enterprises to apportion a share of their worldwide income to California, including the income of foreign parent and subsidiary corporations if their operations were closely integrated or unitary with California business activity.

Under worldwide formulary apportionment, a key issue that California auditors had to determine was whether California corporations that were part of a multinational enterprise were engaged in a unitary business with affiliated U.S. and foreign corporations. This determination was based on a complex analysis of the enterprise's ownership and business operations. Auditors then used the parent corporation's audited financial statements, federal tax returns, and other records to ensure that state tax was based on the income and the apportionment factors for all corporations comprising the unitary business.

In the audits of FCCs that we reviewed, state auditors adjusted income and other apportionment data to account for differences between U.S. and foreign accounting standards and recordkeeping. The auditors focused on differences that they considered to have a material impact. They made six adjustments in the five audits that we studied in depth. State auditors reviewed annual audited financial statements of the foreign parent corporation and requested, but did not always obtain, additional data from taxpayers that were needed to determine the effects of different accounting standards and recordkeeping. As a result, auditors sometimes made determinations on the basis of available data and used estimates and assumptions in making adjustments.

Although we did not discuss whether formulary apportionment should be adopted at the federal level, we did describe matters needing attention before the practice could be adopted. These matters include the design and administration of a federal unitary system. For example, unitary business and apportionment factors would have to be defined and the international feasibility of formulary apportionment, a system opposed by other countries, would have to be considered. We further explained that tax experts disagree on whether the problems associated with such issues could be resolved in a federal system.

Related GAO Product(s)

GAO/GGD-92-89, 06/15/92; GAO/T-GGD-93-16, 03/25/93; and GAO/GGD-95-101, 04/13/95

Other Income Reporting

GAO/GGD-95-199R, 7/19/95

In correspondence to the Commissioner of Internal Revenue, we discussed concerns identified during our analysis of the "Other Income" line of the Individual Income Tax Return as it related to IRS' planned 1994 TCMP. Specifically, we raised concerns about adjustments to the Other Income line and the difficulty associated with using the causal codes planned for the 1994 TCMP.

We reported that auditors sometimes used the Other Income line inappropriately. In some cases, auditors made adjustments to the Other Income line, which should have been shown on another line of the Form 1040. In other cases, taxpayers incorrectly entered income amounts on tax return lines that should have been reported on the Other Income line and IRS auditors reclassified this income, even though TCMP instructions clearly stated that income was not supposed to be reclassified. As a result of these errors, TCMP showed misleading data on compliance for the Other Income line.

We also reported that even though IRS planned to identify causes of noncompliance during the 1994 TCMP, the coding used to identify these causes would be difficult to use. We reported that the codes lacked specificity and that IRS had not developed guidance or criteria on how each type of causal code should be applied. As a result, the usefulness of causal codes may be limited.

Although we made no recommendations, IRS staff agreed to work on improving the areas discussed.

Related GAO Product(s)

GAO/GGD-95-39, 12/30/94 and GAO/T-GGD-95-207, 07/18/95

Issues Involving Worker Classification

GAO/T-GGD-95-224, 08/02/95

Businesses, to determine their tax liability (e.g., employer portion of Social Security and unemployment taxes on employee wages) and meet the requirements of other laws, need to classify their workers as either "employees" or "independent contractors." But, as described in our testimony before the Subcommittee on Taxation and Finance, Committee on Small Business, the common-law rules for classifying workers remain as unclear and subject to conflicting interpretations as we found them in 1977. Thus, businesses continue to be at risk of large retroactive tax assessments for improperly treating workers as independent contractors.

Accordingly, we still believe that the classification rules need to be clarified. But, changes to the classification rules need to be cognizant of the body of laws that create a safety net for American workers. Many laws apply only to employees but do not protect workers classified as independent contractors. Because a by-product of classification rule clarification is the potential for changing the number of workers treated as independent contractors, we believe the current deliberations should also focus on potential impacts on the social safety net established for American workers.

We also believe that there are two approaches that could help improve independent contractor compliance—(1) require businesses to withhold taxes from payments to independent contractors and (2) improve business compliance with the requirements to file information returns on payments to independent contractors. IRS data suggest that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 billion to $30 billion of income taxes owed the federal government by individuals but not paid for tax year 1992.

Related GAO Product(s)

GAO/GGD-77-88, 11/21/77; GAO/GGD-89-107, 09/25/89; GAO/GGD-92-108, 07/23/92; GAO/GGD-94-123, 05/11/94; GAO/T-GGD-94-194, 08/04/94; and GAO/GGD-95-59, 12/28/94

Recurring Issues in Tax Disputes Over Business Expense Deductions

GAO/GGD-95-232, 09/26/95

In a report to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we identified the issues that caused the most frequent disputes between IRS and taxpayers in connection with section 162 of the tax code. Section 162 allows taxpayers to deduct from income "ordinary and necessary" expenses related to trade or business. We had previously reported that section 162 was the tax code section most commonly cited in large tax cases at IRS' Office of Appeals.[2]

To do the work, we reviewed 185 tax court petitions filed in 1993, mostly by sole proprietors and small- and medium-sized corporations as well as partnerships, individual shareholders, and individuals claiming employee business expenses. We also reviewed 117 Office of Appeals cases filed by large corporations included in IRS' Coordinated Examination Program.

In the 185 tax court petitions, we found that sole proprietors, small- and medium-sized corporations, and individuals claiming employee business expenses disagreed with IRS most frequently over the adequacy of documentation for a given expense deduction. About 47 percent of all the issues in the petitions we reviewed involved questions of proper documentation. These disputes were especially frequent in cases where the documentation requirements were the most rigorous—entertainment, travel, meals, and automobile expenses. While documentation was the issue sole proprietors disputed most frequently, small- and medium-sized corporations contested IRS' decisions on the reasonableness of executive salaries as frequently as they did documentation.

Overall, the frequency of disputes over unreasonable executive compensation was far less than disputes involving documentation of business expenses—14 percent versus 47 percent. However, executive compensation accounted for about 50 percent of the total proposed tax

[2]Tax Administration: Recurring Tax Issues Tracked by IRS' Office of Appeals (GAO/GGD-93-101, May 4, 1993).

adjustments—$24.5 million of $48.8 million—in the petitions we reviewed. Adequacy of documentation was the second largest category, at $9.3 million.

In the 117 Office of Appeals cases, we reported that large corporate taxpayers disagreed with IRS most frequently over the issue of capital expenditures, which accounted for about 42 percent of the issues they contested. It was also the issue with the most dollars at stake in the 117 cases, accounting for $1.1 billion of the total $1.9 billion in proposed tax adjustments. In these cases, the corporations argued for immediate deduction of large expenses related to events such as corporate mergers, reorganizations, or environmental cleanups. IRS contended that such expenditures had future benefits and should therefore be treated as capital expenditures, not immediately deductible in the current year.

All of the other issues the large corporations disputed were contested far less frequently than the issue of capital expenditures. For example, documentation questions accounted for only 8 percent of the issues contested, while unreasonable executive compensation accounted for 3 percent.

Related GAO Product(s)

GAO/T-GGD-92-23, 03/17/92 and GAO/GGD-93-101, 05/04/93

Assist Taxpayers

IRS Can Strengthen Its Efforts to See That Taxpayers Are Treated Properly

GAO/GGD-95-14, 10/26/94

At the request of the Chairman and Ranking Minority Member, Subcommittee on Treasury, Postal Service and General Government, House Committee on Appropriations, we reported on how IRS can strengthen its controls in several specific areas and provide taxpayers with additional information that will protect taxpayers from abuse.

IRS has a wide range of controls, processes, and oversight offices designed to govern how its employees interact with taxpayers. While this system of controls has many elements designed to protect taxpayers from abuse, it lacks the key element of timely and accurate information about when, where, how often, and under what circumstances taxpayer abuse occurs. This information would greatly enhance IRS' ability to pull together its various efforts to deal with abuse into a more effective system for minimizing it. The information would also be valuable to Congress in assessing IRS' progress in treating taxpayers as customers—an often cited IRS goal—and to taxpayers to increase their ability to protect their rights.

We also discussed the need for legislation to provide IRS with authorization to disclose information to all responsible officers involved in IRS efforts to collect a trust fund recovery penalty. A trust fund recovery penalty is assessed against the responsible officers and employees of businesses when they fail to collect or pay withheld income, employment, or excise taxes. Relatively large trust fund recovery penalties have caused financial hardships for the individuals involved, particularly for those who were unaware of the legal and financial ramifications of the penalty.

Recommendation(s) to Congress

To better enable taxpayers and IRS to resolve trust fund liabilities, we recommended that Congress amend the Internal Revenue Code to allow IRS to provide information to all responsible officers regarding its efforts to collect the trust fund recovery penalty from other responsible officers.

Recommendation(s) to IRS

To improve IRS' ability to manage its interactions with taxpayers, we recommended that the Commissioner of Internal Revenue establish a service-wide definition of taxpayer abuse or mistreatment and identify and gather the management information needed to systematically track its nature and extent.

To strengthen controls for preventing taxpayer abuse within certain areas of IRS operations, we recommended that the Commissioner of Internal Revenue

- ensure that IRS' systems modernization effort provides the capability to minimize unauthorized employee access to taxpayer information in the computer system that eventually replaces the Integrated Data Retrieval System;
- revise the guidelines for Information Gathering Projects to require that specific criteria be established for selecting taxpayers' returns to be examined during each project and to require a separation of duties between staff who identify returns with potential for tax changes and staff who select the returns to be examined;

- reconcile outstanding cash receipts more often than once a year, and stress in forms, notices, and publications that taxpayers should use checks or money orders whenever possible to pay their tax bills, rather than cash;
- better inform taxpayers about their responsibility and potential liability for the trust fund recovery penalty by providing taxpayers with special information packets;
- seek ways to alleviate taxpayers' frustration in the short term by analyzing the most prevalent kinds of information-handling problems and ensuring that requirements now being developed for new information systems provide for long-term solutions to those problems; and
- provide specific guidance for IRS employees on how they should handle White House contacts other than those that involve checking taxes of potential appointees or routine administrative matters.

Action(s) Taken and/or Pending

IRS supported our recommendation to Congress. Legislation has been introduced in the 104th Congress (H.R. 661 and S. 258) that, if enacted, would require IRS to disclose to a responsible person who requested in writing, the results of its efforts to collect the trust fund recovery penalty from other responsible persons.

IRS disagreed with our recommendation that it establish a definition of taxpayer abuse and identify and gather the information needed to systematically track the nature and extent of such incidents. IRS said that the problem of taxpayer abuse, to the extent that it exists, is best defined, monitored, and corrected within the context of its definitions and current management information systems. Consequently, IRS planned no action on our recommendation.

IRS identified several safeguards that are to be incorporated into systems being developed as part of its systems-modernization effort as well as some recent safeguards that have been incorporated into its existing computer systems. These safeguards include issuing transcripts for account adjustments considered "high risk/high dollar," development of supplemental audit trails, and the generation of locally developed diagnostic transcripts. The Commissioner suggested imposing criminal sanctions on IRS employees who violate privacy policies and Senator John Glenn introduced a bill (S. 670) that would impose up to a $1,000 fine and up to 1 year in jail for unauthorized employee access to taxpayers' accounts.

In February 1995, IRS issued an updated memorandum to the field, stressing the sensitive nature of information-gathering projects and the need for management to closely monitor how these projects are carried out.

IRS plans to amend the Collection Group Managers Handbook to include random unannounced cash reconciliations throughout the year. IRS also has added a statement to Publication 594, "Understanding the Collection Process," encouraging taxpayers to pay by check or money order.

IRS is to include Notice 784, "Could you be personally liable for certain unpaid Federal taxes?," with the first balance due notice for business taxes. IRS currently sends taxpayer education material, including trust fund recovery penalty information, when taxpayers who file an application for an employer identification number indicate they will be liable for trust fund taxes.

IRS stated that through its Quality Review Program and the Problem Resolution Program, it is alleviating information-handling problems that frustrated taxpayers.

Finally, IRS said that its current procedures regarding third-party contacts who provide information that could lead to an audit or investigation are adequate to cover any contacts from the White House. Those procedures essentially call for IRS field office personnel to evaluate the information provided and decide if an audit or investigation is warranted.

Related GAO Product(s)

GAO/T-GGD-91-58, 07/24/91; GAO/GGD-91-112FS, 07/24/91; GAO/T-GGD-92-09, 12/10/91; GAO/GGD-92-23, 12/10/91; GAO/GGD-92-16, 12/31/91; GAO/T-GGD-92-62, 07/22/92; GAO/GGD-92-117, 08/17/92; GAO/IMTEC-92-63, 09/21/92; GAO/T-GGD-92-65, 09/24/92; GAO/GGD-93-67, 05/11/93; and GAO/AIMD-93-34, 09/22/93

IRS Notices Can Be Improved

GAO/GGD-95-06, 12/07/94

Each year, IRS sends millions of notices to taxpayers on the status of their tax accounts. In 1993, IRS sent more than 60 million such notices affecting about $190 billion of taxpayer transactions. As requested by the Subcommittee on Oversight, House Committee on Way and Means, we reviewed 47 commonly used notices for clarity, and we examined IRS' processes for ensuring that the notices it issues convey essential information to taxpayers as clearly as possible.

We identified clarity concerns with 31 of the notices. In reviewing these notices for clarity, understandability, and usefulness, we considered if more specific language, clearer references, and consistent use of terminology would enhance these documents. We assessed whether the material was logically presented, whether sufficient information was provided so taxpayers could evaluate their situations, and whether the taxpayer could resolve the matter without additional guidance. Further, we considered the notice's format, the suitability of the notice's title, the directions or guidance provided in enclosures or remittance forms, and whether IRS provided the taxpayers with all pertinent information in a single notice or whether additional notices were needed. It appears that taxpayers with multiple or interrelated tax problems would be better served by receiving a single, comprehensive notice summarizing the status of their accounts, rather than the stream of multiple notices that IRS now sends them.

Despite IRS' process and commitment of resources to improve notice clarity, in some cases, taxpayers continue to receive notices that IRS' Notice Clarity Unit said were problematic. Many of the notice revisions recommended by that unit were delayed or never made because of IRS' limited computer-programming resources and higher priority programming demands, such as those implementing tax law changes and essential preparation for processing tax returns during the next tax season. Consequently, even revisions with strong organizational support may be significantly delayed.

We found that improvements could be gained from the transfer of notices to Correspondex, a more modern computer system that produces other IRS correspondence. IRS is testing a group of collection notices on this system.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue test the feasibility of using its Correspondex computer system to produce Individual Master File (IMF) and Business Master File (BMF) notices and, if possible, transfer as many IMF and BMF notices as practical to the Correspondex system. To help the transition to Correspondex, we recommended that notices be transferred in stages and that a mechanism be established or an existing body, such as the National Automation Advisory Group, establish the order in which notices would be transferred.

The ease of the transition, the costs of the transfer, and the benefits of making these transfers should all be considered in establishing the order.

We also recommended that the Commissioner establish a system to monitor proposed notice text revisions to oversee progress or problems encountered in improving notice clarity. Employing this system should enable IRS to identify when a revision was proposed and the revision status at all times until it is implemented. The Commissioner should include in the monitoring system a threshold beyond which delays must be appropriately followed up and resolved.

Action(s) Taken and/or Pending

IRS was considering the use of a computerized bulletin board to track proposed notice revisions but tabled that approach because of budget constraints. As of December 31, 1995, IRS officials were exploring other alternatives.

Related GAO Product(s)

GAO/GGD-93-72, 04/30/93; GAO/GGD-95-34, 12/07/94; and GAO/T-GGD-95-42, 12/09/94

IRS Efforts to Improve Forms and Publications

GAO/GGD-95-34, 12/07/94

At the request of the Subcommittee on Oversight, House Committee on Ways and Means, we examined IRS' efforts to improve its forms and publications to ensure accuracy and clarity. Providing taxpayers with easy-to-read tax forms and publications is one way of promoting voluntary compliance; however, it is a difficult task. IRS must strike a balance between the need for tax documents that accurately reflect a highly complex tax code and the need to make these documents understandable and easy to read. Finding this balance is an ongoing process, as the tax code is frequently revised—necessitating corresponding changes in forms and publications. Other factors, such as the wide range of taxpayers' reading abilities, further complicate IRS' task. IRS' process for developing and revising its forms and publications appears reasonable in that it provides for clear lines of responsibility and accountability, specific time frames, adequate management oversight, sufficient opportunities to evaluate suggestions from internal and external sources, and appropriate strategies for coping with sudden tax law changes.

Despite IRS' process for developing forms and publications and its stated commitment to improvement, IRS recognizes that it has no systematic way to determine what individual taxpayers specifically find confusing about forms and publications. IRS has established a dialogue with professional organizations to obtain their concerns but not with individual taxpayers. IRS may already have data that could help it identify areas that are difficult for individual taxpayers. These potential sources of data include information from its toll-free telephone assistance program and field personnel, such as auditors and customer-service representatives, who have contact with individual taxpayers.

Recommendation(s) to IRS

We recommended that the Commissioner direct agency staff to make additional efforts to identify the specific concerns of individual taxpayers. Identifying these concerns may be accomplished in a variety of ways, including (1) soliciting information from IRS field personnel (e.g., auditors, examiners, and customer-service representatives) for the purpose of identifying common errors made by taxpayers, which may be related to confusing passages in forms and publications and (2) gathering information concerning the nature of taxpayer questions received through its toll-free telephone system.

Action(s) Taken and/or Pending

During 1995, IRS personnel attended town meetings in several cities and provided the Tax Forms and Publications Division information on taxpayers' problems with forms and publications. Division representatives planned to meet with IRS assistors who answer taxpayers' calls for assistance to obtain suggestions for improving the forms and publications, on the basis of the assistors' experience in dealings with taxpayers.

Related GAO Product(s)

GAO/GGD-93-72, 04/30/93; GAO/GGD-95-06, 12/07/94; and GAO/T-GGD-95-42, 12/09/94

Information on Tax Liens Imposed by IRS

GAO/GGD-95-87R, 03/03/95

At the request of Senator Jesse Helms, we researched several issues raised by a constituent. We provided in some detail information about tax liens imposed by IRS and how such liens might be removed.

A general tax lien arises when a tax assessment has been made and the taxpayer has been given notice and demand for payment but has failed to pay. A notice of tax lien provides public notice that a taxpayer owes the government money. Once a lien is imposed, however, it cannot be removed except under one of the circumstances discussed below.

As a result of the Taxpayer Bill of Rights, for example, any person whose property is encumbered by a tax lien is permitted to administratively appeal the filing of the lien on the ground that it was filed erroneously. Using this procedure, the taxpayer can apply for a special certificate of release of lien that indicates that the filing of the lien was a mistake. This certificate is intended to ensure that the public record shows that the filing of the notice of lien was not the result of the taxpayer's actions and to help repair the taxpayer's credit record. In addition, there are four other possible avenues of relief from a tax lien. They are (1) a certificate of nonattachment, (2) a certificate of release of lien, (3) a certificate of discharge, and (4) a certificate of subordination.

IRS believes, and we agree, that the Internal Revenue Code seems to prohibit IRS from withdrawing the notice of lien in instances where the notice of lien is on the public record, which might deprive the taxpayer of an opportunity to obtain the funds needed to pay taxes. Therefore, we suggested in a report[3] that Congress amend the code to provide IRS with specific authority to withdraw a notice of lien in situations where such action would be advantageous to IRS and the taxpayer.

In 1992, Congress twice approved taxpayer rights measures that included provisions that would have given IRS increased flexibility in providing relief from lien filings, including withdrawing notices of lien in situations where withdrawal of the notice would be in the best interest of the taxpayer and the government. However, for reasons having nothing to do with the lien provisions, both measures were vetoed by then President Bush.

More recently, on January 23, 1995, proposed legislation was again introduced in Congress—S. 258 in the Senate and H.R. 661 in the House of Representatives—that includes a lien provision similar to the provisions in the 1992 legislation discussed above. As of December 31, 1995, no action had been taken on those proposals.

Related GAO Product(s)

GAO/GGD-92-23, 12/10/91

[3]IRS' Implementation of the 1988 Taxpayer Bill of Rights (GAO/GGD-92-23, Dec. 10, 1991).

Adopting Practices Used by Others Would Help IRS Serve More Taxpayers

GAO/GGD-95-86, 04/12/95

Many taxpayers who seek help through IRS' telephone assistance program are not getting it. Even with increased productivity, IRS has not kept pace with the significant growth in the number of calls received over fiscal years 1989 to 1994. IRS' assistors answered about the same number of calls each year (about 36 million) even though the staff available to answer calls declined. IRS answered about one out of two calls in fiscal year 1989 but only one out of four calls in fiscal year 1994.

In a report to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we examined IRS' telephone assistance program to (1) determine the extent and nature of the accessibility problem, (2) compare IRS' practices with those of other organizations that provide telephone assistance to identify ways IRS might improve access with existing staff resources, and (3) identify the reasons IRS has been unable to answer more calls.

IRS has improved its telephone assistance program, particularly its capability to route calls among call sites and provide assistors with taxpayers' account information. However, IRS' telephone management practices, including the ability to apply modern information technology, have not kept up with those commonly used to enhance call answering by the Social Security Administration (SSA) and four private sector companies we contacted.

It is unlikely that IRS could answer all taxpayers' calls with current staff and technology resources. However, we believe that IRS could apply additional management practices used by other organizations to answer more calls with existing resources.

IRS does not use several of the practices commonly used by the other organizations we contacted, and some of those IRS uses are not as rigorous or advanced as the practices these organizations employed. For example, in fiscal year 1995, for the first time, IRS provided all taxpayers access to telephone assistors for a total of 10 hours a day. In contrast, SSA offered access to assistors 12 hours a day, and all of the companies we contacted routinely provided access to a customer-service representative 24 hours a day.

IRS has fallen behind the other telephone assistance programs in some areas primarily because IRS' senior management has not aggressively and consistently pursued the implementation of commonly used practices. In part, these attempts failed because IRS did not have a strategy for working with the National Treasury Employees Union (NTEU), which represents most IRS telephone assistance employees, to implement systemwide operating practices and standards. IRS and NTEU have recently reached an agreement to work together to implement IRS' future Customer Service Vision. We believe that IRS could use this framework now to put in place telephone assistance program practices used by others to optimize the number of taxpayers' calls it can answer.

IRS has a model for the type of aggressive management attention we believe is necessary. IRS created the model in its successful effort to improve the accuracy of the answers it provides to taxpayers' tax law questions. IRS could use this model as the basis for identifying and applying appropriate telephone management practices to increase the number of taxpayers' calls IRS answers.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue direct the Chief of Taxpayer Services, in coordination with other appropriate IRS officials, to lead an aggressive effort to (1) identify and define the appropriate telephone assistance program operating practices for IRS that would allow it to optimize the number of calls it can answer within current budget constraints and (2) work with the leadership of NTEU to reach agreement on implementing those practices on a nationwide basis. Those practices should include, although not be limited to,

- challenging program goals for increasing the number of calls answered that are based, at least in part, on taxpayers' needs;
- standards for the amount of time assistors should be available to answer taxpayers' calls;
- hours of operation that offer taxpayers greater opportunity to reach IRS assistors; and
- uniform reporting definitions for the number of calls answered and other performance measures.

We also recommended that the Commissioner of Internal Revenue direct the Chief of Taxpayer Services to quickly take the steps necessary to effectively route taxpayers' calls nationwide using real-time information. These steps may include a combination of (1) acquiring technology for real-time traffic monitoring and management, (2) utilizing the routing capability of IRS' telecommunications vendor, and (3) fully implementing the features of IRS' existing call routing technology.

Action(s) Taken and/or Pending

IRS agreed that more progress can be made in implementing industry best practices. IRS plans to provide, before the 1996 filing season, servicewide standards pertaining to the amount of time assistors should be available to answer taxpayers' calls. IRS is also pilot testing three interactive telephone applications at one call site that require no IRS employee involvement and will therefore free telephone assistors to answer other inquiries. IRS plans to offer Saturday service on six peak Saturdays and on President's Day during the 1996 filing season. This is an increase from three Saturdays in 1995. In addition, IRS plans to continue offering service 10 hours daily to callers. IRS reported that during the 1995 filing season, it took a more aggressive approach to routing traffic to equalize access that resulted in over 500 traffic shifts. Additionally, it sought assistance from its telecommunications vendor to delineate the full range of call routing technologies that it plans to implement for the 1996 filing season.

Related GAO Product(s)

GAO/GGD-91-83, 06/12/91; GAO/GGD-91-98, 06/28/91; GAO/T-GGD-92-33, 04/28/92; GAO/GGD-92-132, 09/15/92; GAO/GGD-92-139FS, 09/22/92; GAO/GGD-94-65, 12/22/93; GAO/GGD-94-131, 08/29/94; GAO/GGD-95-5, 10/07/94; and GAO/T-GGD-95-97 02/27/95

Enhance Effectiveness of Tax Incentives

Tax-Exempt Organizations

GAO/GGD-95-84BR, 02/28/95; GAO/T-GGD-95-183, 06/13/95; and GAO/T-GGD-95-198, 06/29/95

Internal Revenue Code section 501(c) establishes 25 categories of tax-exempt organizations that enjoy many benefits that for-profit companies do not. In particular, tax-exempt organizations are required to pay federal income taxes only on unrelated business income. They are also exempt from many state and local taxes. In addition, contributions to tax-exempt charities are deductible from donors' federal income taxes. IRS is responsible for monitoring the activities of tax-exempt organizations through examinations of their annual returns. IRS' interest is in determining whether the organizations are operating in accordance with the basis for their exemptions and whether they are liable for income taxes from unrelated trades or various excise taxes. We received three requests[4] to provide information for congressional deliberations on the growth of these organizations, their activities, and IRS oversight.

We found that, overall, tax-exempt organizations have grown in number and size since the mid-1970s, from 806,375 to over 1 million in 1990 (about 27 percent). Between 1975 and 1990, their assets have grown in real terms over 150 percent to more than $1 trillion, and their revenues have grown over 225 percent to about $560 billion. Charities represented about 48 percent of the total tax-exempt organizations; social welfare organizations, about 14 percent; labor and agricultural organizations, about 7 percent; and business leagues, about 6 percent. The other 25 percent were scattered among the remaining 21 categories. We also discussed complex tax code provisions, which can cause compliance and administrative difficulties resulting in numerous IRS rulings and court cases and sometimes the revocation of an organization's tax-exempt status.

Related GAO Product(s)

GAO/GGD-85-64, 07/08/85 and GAO/GGD-87-40BR, 02/27/87

Earned Income Credit: Targeting to the Working Poor

GAO/GGD-95-27, 10/25/94; GAO/GGD-95-122BR, 03/31/95; GAO/T-GGD-95-136, 04/04/95; and GAO/T-GGD-95-179, 06/08/95

The Earned Income Credit (EIC) is a major federal effort to assist the working poor. Congress established the EIC in 1975 to (1) offset the impact of Social Security taxes on low-income workers and (2) encourage low-income individuals to seek employment rather than welfare. IRS reported that, as of May 26, 1995, about 17.3 million returns claimed nearly $20 billion in EIC for tax year 1994. However, there have long been concerns in Congress and IRS about noncompliance with EIC requirements and whether those eligible for the EIC are receiving it.

At the request of Senator William V. Roth, Jr., we presented information about EIC noncompliance and IRS' steps to control it. We also reviewed the impact on the amount of EIC paid and administrative issues that might result from potential changes to the EIC eligibility criteria that would

[4]Senators Byron L. Dorgan and Harry Reid; Chairman, Subcommittee on National Economic Growth, National Resources, and Regulatory Affairs, House Committee on Governmental Reform and Oversight; and Chairman, Subcommittee on Social Security and Family Policy, Senate Committee on Finance.

reflect taxpayer wealth and additional sources of income. Further, we provided information about illegal aliens receiving the EIC.

We reported that a reliable overall measurement of noncompliance with EIC provisions has not been made since 1988. IRS did a 2-week study in January 1994 and found that 39 percent of persons who filed returns electronically claimed an EIC that they were not entitled to receive, and 26 percent of the refund amounts sought were overclaims. Noncompliance on EIC paper returns is also a concern. IRS took several steps during the 1995 filing season to combat fraudulent or erroneous returns, especially EIC returns. IRS also undertook a study to determine the overall level of EIC compliance—on paper and electronically filed returns throughout the 1995 filing season.

We reported that EIC eligibility criteria had not considered all of the resources recipients may have to support themselves and their families. We provided analyses related to using both an EIC wealth test and an expanded definition of taxpayers' adjusted gross incomes when making EIC awards. The Joint Committee on Taxation estimated that denying the EIC to taxpayers who have some wealth, as indirectly measured by their asset-derived income, could yield $318 to $971 million in revenue savings in fiscal year 1997, depending on the wealth test design. These revenue savings represent potential reductions in EIC program costs resulting from changing EIC eligibility criteria. We cautioned that these changes would make the EIC more complex and add to the burden on taxpayers and IRS.

We also reported that no one knows how many illegal aliens receive the EIC. If the EIC criteria were revised to require that all EIC recipients have valid SSNs for work purposes, which illegal aliens are not eligible to receive, then illegal aliens would no longer qualify for the EIC.

Action(s) Taken and/or Pending

The Self-Employed Health Insurance Act of 1995 included a proxy measure of taxpayers' wealth to be used in determining EIC awards. Effective in 1996, EIC claimants who have income that exceeds $2,350 from certain types of assets will be ineligible for the EIC. Congressional proposals are being considered that would add certain income items to taxpayers' adjusted gross income when determining their EIC awards.

Related GAO Product(s)

GAO/GGD-93-145, 09/24/93 and GAO/GGD-94-99, 05/02/94

Information on the Research Tax Credit

GAO/T-GGD-95-140, 04/03/95 and GAO/T-GGD-95-161, 05/10/95

In testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight of the Senate Committee on Finance and in testimony before the Subcommittee on Oversight of the House Committee on Ways and Means, we provided information on the research tax credit. Congress created the research tax credit in 1981 to encourage the business community to do more research. The credit applies to qualified research spending that exceeds a base amount. The credit's availability expired in June 1995.

In tax year 1992, corporations earned more than $1.5 billion worth of research credits, most of which was earned by large corporations in the manufacturing sector, particularly those producing chemicals (including drugs), electronic machinery, motor vehicles, and nonelectronic machinery. The research credit has been difficult for IRS to administer, primarily because the definition of spending that qualifies for the credit was unclear. In 1994, the Department of the Treasury issued final regulations that may resolve this uncertainty.

We noted in our testimony that the credit's net benefit to society would ideally be evaluated in terms of the ultimate benefits derived from the additional research that it stimulates and not just on the basis of how much research spending it stimulates for a given revenue cost. However, no one has been able to estimate the credit's net benefit to society. Given the absence of empirical data, we have not taken a position on whether the credit should be made a permanent part of the tax code.

Congress made revisions to the credit in 1989 that should have increased the amount of spending stimulated per dollar of revenue cost. But, over time, the fixed base of the revised credit has the potential to become too generous for some taxpayers, resulting in undue revenue losses and too restrictive for others, resulting in less overall research stimulated by the credit. We presented evidence from corporate tax returns indicating that the accuracy of the credit's base has eroded significantly since 1989.

Matter(s) for Congressional Consideration

Given that the base of the credit may become too generous or too restrictive over time, we suggested that Congress may want to provide for reviewing this base periodically and adjusting it as needed.

Action(s) Taken and/or Pending

In the Budget Reconciliation Bill (H.R. 2491), Congress proposed to extend the credit for the period July 1, 1995, through December 31, 1997. This bill also provided taxpayers the option to elect an alternative calculation of the credit that provides lower base amounts and lower rates of credit. This alternative calculation may have eased the restrictiveness of the credit for some taxpayers. However, the President vetoed this legislation.

Related GAO Product(s)

GAO/GGD-89-114, 09/05/89 and GAO/GGD-94-139, 05/13/94

Recovering Hundreds of Millions in Welfare Benefits Overpayments

GAO/HEHS-95-111, 06/20/95

In 1992, people who were not entitled to welfare benefits, or not entitled to the level of benefits provided, received an estimated $4.7 billion in benefit payments by three of the nation's largest welfare programs—Aid to Families With Dependent Children (AFDC), Food Stamps, and Medicaid. These overpayments represent about 4 percent of the total benefits paid in these programs. Nationwide state recovery of the overpayments, about $333 million, was relatively low. We were asked by the Ranking Minority Member, Subcommittee on Oversight of Government Management, Senate Committee on Governmental Affairs, to determine what the states were doing to recover benefit overpayments and what the federal government could do to help states recover more overpayments.

We found that states with the highest recovery rates were establishing claims for a greater portion of their overpayments and used certain practices, and more of them, than did states with lower recovery rates. These practices included more timely efforts to verify potential overpayments and establishing claims for overpayments on more difficult cases.

We also reported that, while temporarily reducing benefits to recover overpayments is an effective collection method in the AFDC program, by law, it cannot be used in the Food Stamp Program to collect overpayments caused by agency error unless the client consents. In 1985, a legislative proposal to require recoupment of Food Stamp benefits, without client consent, for agency error overpayments was introduced but not enacted. Subsequently, in 1993, the U.S. Department of Agriculture proposed legislation that recommended recoupment of agency error claims, but the Congress did not act on the recommendation.

In addition, we reported that extending the use of federal income tax refund intercept—an effective overpayment collection tool in the Food Stamp Program—to AFDC and Medicaid could potentially increase recoveries. Legislation to extend federal income tax refund intercept to the AFDC program had been introduced in 1994 but did not pass. The legislation, part of a welfare reform proposal introduced in the 103rd Congress, would have authorized an intercept program for AFDC overpayments. Commenting on this proposal, officials from Treasury's Financial Management Service cited the need to revise the proposal's language so that the Health and Human Services' Administration for Children and Families would be the focal point for working with the IRS. This would lessen the administrative burden on IRS because it could deal with one entity rather than the 50 states and the District of Columbia. This approach would more closely resemble the Food Stamp intercept program, which uses Agriculture's Food and Consumer Service as its focal point.

Matter(s) for Congressional Consideration

We suggested that Congress consider amending federal legislation to (1) authorize states to offset current recipients' benefits without client consent to recover Food Stamp overpayments caused by agency error and (2) extend the authority for states to intercept federal income tax refunds to include the recovery of AFDC and Medicaid overpayments.

Action(s) Taken and/or Pending

IRS comments were not received in time to be incorporated into our report. Legislative provisions in the Personal Responsibility and Work Opportunity Act of 1995 (H.R. 4), approved by both houses of the 104th Congress, address both of our matters for congressional consideration. As of December 31, 1995, this bill had not been signed.

Related GAO Product(s)

GAO/RCED-86-17, 03/14/86

Improve IRS Management

Internal Revenue Service Receivables

GAO/HR-95-6, 02/95

We identified IRS' management of accounts receivable as an area of high risk vulnerable to waste, fraud, abuse, and mismanagement. This report was 1 of a series of 18 reports identifying weaknesses in agencies' internal controls or financial management systems. The 1995 series of high-risk reports was an update to the original series issued in December 1992.

IRS' management of accounts receivable also has been recognized by the Office of Management and Budget (OMB) and IRS management as a high-risk area. IRS' poor performance in resolving tens of billions of dollars in outstanding tax delinquencies has not only lessened the revenues immediately available to support government operations but could also jeopardize future taxpayer compliance by leaving the impression that IRS is neither fair nor serious about collecting overdue taxes.

We reported that despite many IRS initiatives to "fix" the accounts receivable problem, negligible progress has been made. For example, IRS has not yet developed an accounting system that identifies valid and collectible receivables and those that are not, thereby complicating the job of collection personnel trying to resolve individual accounts. Also, from 1990 through 1994, the gross inventory of tax debt, which includes accounts receivable, grew about 80 percent—from $87 billion to $156 billion. During the same period, annual collections of delinquent taxes declined from $25.5 billion to $23.5 billion—a decline of about 8 percent.

We noted that these disappointing results are indicative of the (1) pervasiveness of problems throughout IRS' processes that cumulate in the inventory and (2) difficulty in coming to grips with the interrelationship of several underlying causes. These include the lack of accurate and reliable management information for determining the validity and makeup of the inventory of tax debt and evaluating the effectiveness of individual collection activities; IRS' lengthy, antiquated, rigid, and inefficient collection process; difficulty in balancing collection efforts with the need to protect taxpayer rights; and a decentralized organization that blurs responsibility and accountability.

In our view, IRS' primary task is twofold: collect more delinquent taxes and stem the growth in outstanding debts. The first part of the task requires greater efficiency and productivity in the collection process. The second requires changes in other IRS components to prevent delinquencies and minimize cluttering up the collection process with invalid and uncollectible accounts.

The lack of accurate and reliable information continues to be IRS' foremost problem and hinders most of its efforts to effectively deal with tax debts. Priority must be given to this area because so many of IRS' modernization efforts rely heavily on accurate and reliable information. IRS also needs to clearly demonstrate the institutional focus necessary to effectively deal with the underlying causes of the problem—causes that cut across the agency and across lines of managerial authority and responsibility. Equally important is that the strategy address ways to best reengineer IRS' outmoded tax collection processes, which were designed decades ago and have not kept pace with advances in technology or communications.

Related GAO Product(s)

GAO/AFMD-93-42, 05/06/93; GAO/GGD-93-67, 05/11/93; GAO/HR-95-1, 01/95; GAO/HR-95-2, 01/95; GAO/AIMD/GGD-95-220R, 08/03/95; and GAO/AIMD-95-141, 08/04/95

Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed

GAO/T-AIMD-95-86, 02/16/95 and GAO/AIMD-95-156, 07/26/95

Since 1986, IRS has invested $2.5 billion in Tax Systems Modernization (TSM). In addition, it requested another $1.1 billion for fiscal year 1996 for this effort and, through 2001, expected to spend over $8 billion on TSM. TSM is the centerpiece of IRS' vision of virtually paperless tax processing to optimize operations and serve taxpayers better. This report and testimony critique the effectiveness of IRS' efforts to modernize tax processing. We discuss IRS' progress to implement its modernization and describe serious remaining management and technical weaknesses that must be corrected if tax systems modernization is to succeed.

We found that IRS recognizes the criticality to future efficient and effective operations of attaining its vision of modernized tax processing and has worked for almost a decade, with substantial investment, to reach this goal. However, its efforts to modernize tax processing are at serious risk because of remaining pervasive management and technical weaknesses that impede modernization efforts. Specifically, we found the following:

- IRS does not have a comprehensive business strategy to cost-effectively reduce paper submissions. IRS' business strategy primarily targets taxpayers who use a third party to prepare and/or transmit simple returns, are willing to pay a fee to file their returns electronically, and are expecting refunds. Focusing on this limited taxpaying population overlooks most taxpayers, including those who prepare their own tax returns using personal computers.

- Strategic information management practices are not fully in place to guide systems modernization.
- Software development capability is immature and weak. Using the Capability Maturity Model (CMM) developed by the Software Engineering Institute at Carnegie Mellon University, IRS rated itself at the lowest level (i.e., CMM level 1).
- Systems architectures (including its security architecture and data architecture), integration planning, and system testing and test planning were incomplete.
- An effective organizational structure to consistently manage and control systems modernization organizationwide was not established.

Recommendation(s) to IRS

To overcome the management and technical weaknesses impeding successful modernization efforts, we recommended that IRS' electronic filing business strategy focus on a wider population of taxpayers, including taxpayers who can benefit from filing electronically. In addition, we recommended the following improvements to IRS' strategic information management, software development capability, and technical activities.

- Take immediate action to improve IRS' strategic information management by implementing a process for selecting, prioritizing, controlling, and evaluating the progress and performance of all major information systems investments, both new and ongoing, including explicit decision criteria. Using the best available information, IRS needs to develop quantifiable decision criteria that consider such factors as cost, mission benefits, and technical risk.
- Immediately require IRS' future software development contractors to have CMM level 2 maturity and by December 31, 1995, take measures that will improve IRS' software development capability. The specific measures recommended are intended to move IRS to CMM level 2 and include implementing consistent procedures for software requirements management, quality assurance, configuration management, and project planning and tracking.
- Take several actions by December 31, 1995, to improve key system development technical activities. These specific actions include (1) completing an integrated systems architecture and security and data architectures, (2) institutionalizing formal configuration management for all new systems development projects and upgrades and developing a plan to bring ongoing projects under formal configuration management, and (3) developing security concept of operations, disaster recovery, and contingency plans.

- Assign the Associate Commissioner responsibility for managing and controlling all systems development activities, including the research and development division's systems development efforts.

Action(s) Taken and/or Pending

IRS officials agreed with our recommendations for improving TSM in areas such as electronic filing, strategic information management, software development, technical infrastructure, and accountability and responsibility. IRS officials are currently drafting a legislatively mandated report, which is required to include a schedule for successfully mitigating the deficiencies we reported.

Related GAO Product(s)

GAO/T-AIMD/GGD-94-104, 03/02/94; GAO/AIMD-94-120, 06/15/94; GAO/T-GGD-95-74, 02/01/95; and GAO/HR-95-1, 02/95

Analysis of IRS' Fiscal Year 1996 Budget Request and Interim Results of 1995 Filing Season

GAO/T-GGD-95-97, 02/27/95

At the request of the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we testified on the administration's fiscal year 1996 budget request for IRS and on the interim results of our assessment of the 1995 tax filing season.

IRS' fiscal year 1996 budget request was for about $8.2 billion and 114,885 staff, an increase of about $739 million and 922 staff over IRS' expected fiscal year 1995 operating level. Most of the increase was for TSM. Other increases were to help IRS deal with two important filing season issues—the need to better control refund fraud and the difficulties taxpayers experience in trying to reach IRS by telephone. We made the following points in our testimony:

- To focus the TSM effort, IRS should direct its attention to a small number of projects that address critical gaps in mission performance and are part of the TSM vision. In light of the need to refocus TSM, IRS might not be in a position, in fiscal year 1996, to effectively use all of the funding for TSM that it had requested.
- IRS took several steps in 1995 in an attempt to better control refund fraud. As one result of these changes, IRS was delaying the refunds of many taxpayers whose eligibility for the EIC was problematic or who were not using valid SSNs. We expressed the belief that these actions, if effectively implemented, should help reduce refund fraud.

- Refundable credits, like the EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there are equally important concerns that not all taxpayers who are eligible are receiving the credit. We made several recommendations in past reports that could help make the EIC less of a problem.
- Taxpayers were continuing to have problems reaching IRS by telephone. Of the 1,166 calls we made to IRS' toll-free assistance number between January 30 and February 10, 1995, we reached an IRS assistor 13 percent of the time.
- IRS' budget included a request for additional staff to answer the telephones. Although the requested increase would help, it would not make an appreciable difference in the large gap between the number of calls coming into IRS and the number it answers. Most taxpayers might be able to get through to IRS if IRS adopted some of the practices used by other large organizations that provide similar telephone assistance.

Related GAO Product(s)

GAO/GGD-92-26, 02/19/92; GAO/GGD-93-27, 12/30/92; GAO/GGD-93-60, 03/19/93; GAO/GGD-93-145, 09/24/93; GAO/GGD-94-65, 12/22/93; GAO/T-GGD-94-89, 02/10/94; GAO/GGD-94-129, 04/20/94; GAO/GGD-95-5, 10/07/94; GAO/GGD-95-86, 04/12/95; and GAO/AIMD-95-156, 07/26/95

Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements

GAO/AIMD-95-141, 08/04/95

This report presented the results of our attempt to audit IRS' financial statements for fiscal year 1994. It also assessed IRS' internal controls and compliance with laws and regulations. The report further discussed the scope and severity of IRS' financial management and control problems and the effect these problems have had on IRS' ability to carry out its mission and remedy these problems.

IRS continues to face major challenges in developing meaningful and reliable financial management information and in providing adequate internal controls that are essential to effectively manage and report on its operations. Overcoming these challenges is difficult because of the long-standing nature and depth of IRS' financial management problems and the antiquated state of its information systems. We were unable to express an opinion on the reliability of IRS' financial statements for fiscal year 1994, as in other years.

We found that (1) critical supporting information for IRS financial statements was not available; (2) the available information was generally unreliable due to ineffective internal controls; and (3) IRS internal controls did not effectively safeguard assets, provide a reasonable basis for determining material compliance with laws and regulations, or ensure that there were no material misstatements in the financial statements. IRS, however, has made progress in responding to our previously identified problems and in improving accounting for federal revenues.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue direct the Chief Financial Officer to

- implement the software, hardware, and procedural changes needed to create reliable subsidiary accounts receivable and revenue records that are fully integrated with the general ledger;
- change the current federal tax deposit coupon reporting requirements to include detailed reporting for all excise taxes, Federal Insurance Contribution Act (FICA) taxes, and employee withheld income taxes; and
- implement software changes that will allow the detailed taxes reported to be separately maintained in the master file, other related revenue accounting feeder systems, and the general ledger.

Action(s) Taken and/or Pending

IRS is working with us to implement these recommendations as well as those from our prior financial audits. Some progress has been made in responding to problems we identified in previous reports. IRS officials reaffirmed their commitment to the goals of the Chief Financial Officer Act to improve financial management and to provide stakeholders and managers with accurate and timely financial information.

Related GAO Product(s)

GAO/IMTEC-88-41, 06/17/88; GAO/GGD-89-1, 10/14/88; GAO/AIMD-94-120, 06/15/94; GAO/T-AIMD-94-164, 07/28/94; GAO/HR-95-1, 02/95; and GAO/HR-95-6, 02/95

Improve the Processing of Returns and Receipts

Continuing Problems Affect Otherwise Successful 1994 Filing Season

GAO/GGD-95-5, 10/07/94

At the request of the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we assessed various aspects of IRS' performance during the 1994 tax filing season. Specifically, we looked into the processing of individual income tax returns and related refunds and the ability of taxpayers to reach IRS by telephone.

The 1994 filing season was successful in many respects. The number of returns filed increased after an unexpected decline in 1993, and more taxpayers used alternatives to the traditional paper filing method. According to IRS data and our review at one of IRS' 10 service centers, tax refunds were generally processed accurately and issued in a timely manner, and IRS improved the accuracy of its returns processing, thus reducing the amount of rework. IRS' computers generally worked well with minimal downtime. On the basis of tests done by us and IRS, taxpayers looking for tax forms and publications at IRS walk-in sites could reasonably expect to find them, and taxpayers calling IRS' toll-free telephone assistance with tax law questions could generally expect to get accurate answers. However, there were some significant problems.

- The number of IRS-detected fraudulent refund claims continued the steady increase that has plagued IRS for the past several years. Through the first 6 months of 1994, IRS identified twice as many fraudulent claims as it had during the same period in 1993. What remained unclear was (1) how much of that growth was due to increased fraudulent activity versus improved IRS monitoring and (2) how much additional fraud might be going undetected.
- The ability of taxpayers to reach IRS by telephone has been a problem for several years and degraded even further in 1994. Using IRS data, we determined that (1) only about 20 percent of the calls to IRS' toll-free telephone assistance and 50 percent of the calls to IRS' forms distribution centers were being answered and (2) only 13 percent of the calls to IRS' TeleFile system were getting through during the peak period. Under TeleFile, certain taxpayers who are eligible to file a Form 1040EZ are allowed to file using a toll-free number on touch-tone telephones.

- The EIC was the source of many errors by taxpayers and tax practitioners in preparing returns. Those errors, along with errors by IRS staff in following IRS procedures for handling EIC claims, increased IRS' error resolution workload and delayed taxpayers' receipt of benefits.

We did not make any recommendations to address these significant problems because (1) there were several efforts already under way and planned that we expected would have a positive effect on these issues, such as a review of refund fraud being done by Treasury's Fraud Task Force and IRS' plans to increase the number of telephone lines for TeleFile and (2) we had other work under way, which was specifically targeted at those issues and might help us better identify root causes.

Related GAO Product(s)

GAO/GGD-91-23, 12/27/90; GAO/GGD-91-98, 06/28/91; GAO/GGD-92-132, 09/15/92; GAO/GGD-93-27, 12/30/92; GAO/GGD-94-65, 12/22/93; GAO/GGD-95-27, 10/25/94; GAO/GGD-95-86, 04/12/95; and GAO/T-GGD-95-179, 06/08/95

Changes Needed to Reduce Volume and Improve Processing of Undeliverable Mail

GAO/GGD-95-44, 12/07/94

In a report to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we presented the results of our review of IRS' processes for handling undeliverable mail. Our work focused on notices IRS sent to taxpayers involving the assessment and collection of taxes.

We reported that IRS sends out millions of pieces of mail each year to taxpayers and that during fiscal year 1992, about 15 million pieces were undeliverable. According to IRS, mail is undeliverable because (1) taxpayers move and leave no forwarding addresses with the U.S. Postal Service or IRS, (2) the Postal Service may not deliver or forward mail, and (3) IRS may incorrectly record taxpayers' addresses in its files.

While the exact costs are not determinable, IRS estimated that it loses millions of dollars annually in revenues and incurs increased operations costs from undelivered mail. One projection indicated that a minimum of $100 million in lost revenue per year may be attributable to undeliverable mail addressed to business taxpayers alone. IRS estimates also showed that the volume of undeliverable mail rose from 6.5 million pieces in 1986 to about 15 million pieces in 1992.

We noted that it is unlikely that IRS can totally eliminate undeliverable mail because two of its three principal causes are external to IRS. However, IRS needs to give this type of mail more attention because it adversely affects taxpayers and IRS. When IRS sends mail that is undelivered and subsequent attempts to contact the taxpayers are unsuccessful, the consequences for taxpayers can be quite severe. For example, the amount of taxes owed can grow, as interest and penalties mount, and liquid assets such as bank accounts may eventually be levied to satisfy the debt.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue encourage taxpayers to make address changes by (1) accepting changes of address over the telephone; (2) making Form 8822, Change of Address, more conveniently available; and (3) emphasizing to taxpayers the importance of keeping their addresses current with IRS.

We also recommended that IRS proceed with plans to establish a centralized unit within each of its service centers to process all service center undeliverable mail.

Action(s) Taken and/or Pending

IRS agreed with our recommendations and is working with its Chief Counsel to revise a procedure to allow accepting general address changes over the telephone. IRS is also conducting several tests to make address changing easier. For example, IRS is including change of address forms in Postal Service change of address kits. Efforts are also under way to update taxpayer education materials regarding IRS' need for current addresses and the procedures for changing addresses.

IRS is examining various alternatives for standardizing undeliverable mail procedures, including the establishment of centralized units. In addition, IRS is planning to establish locator service procedures and locator service units at all service centers.

Related GAO Product(s)

GAO/T-GGD-94-186, 09/26/94

Process Used to Revise Federal Employment Tax Deposit Regulations

GAO/GGD-95-08, 12/29/94

In July 1990[5], we reported that the rules for depositing employment taxes were complex and resulted in nearly one-third of all employers being

[5]Federal Tax Deposit Requirements Should Be Simplified (GAO/GGD-90-102, July 31, 1990).

penalized in 1988 for failing to make timely deposits. We recommended that IRS simplify the employment tax deposit rules by making the deposit date more certain and by exempting significant numbers of small employers from frequent deposit requirements. At the request of Senator Herbert Kohl, we reviewed the development of the revised federal employment tax deposit regulations issued by the Department of the Treasury and IRS.

We reported that the final regulations, issued in September 1992, launched a new payroll tax deposit process that was widely considered to be significantly simpler and easier for stakeholders to understand and comply with. The regulations provided all but the largest employers with a fixed-deposit rule that they can follow for an entire calendar year. IRS obtained stakeholders' input, either oral or written, throughout the process. Although stakeholders were generally satisfied with the outcome, they differed in their satisfaction with the process used in developing them. Some concerned stakeholders did not believe that an adequate dialogue had been established with Treasury or IRS officials and that Treasury and IRS officials did not follow statutory or executive branch guidance that either appeared to be applicable or that the stakeholders thought would have been appropriate to follow, i.e., the Regulatory Flexibility Act or Executive Order 12291.

We concluded that given such things as the diversity of interests among the stakeholders who may be affected by tax regulations, the time constraints under which Treasury and IRS officials often must operate, and the sometimes conflicting goals that must be reconciled when tax regulations are written, complete stakeholder satisfaction is unlikely. Nevertheless, the employment tax deposit regulation experience suggests that Treasury and IRS officials could modify their practices to improve communications with stakeholders and provide greater assurance that stakeholders' views will be obtained and considered.

Recommendation(s) to the Secretary of the Treasury

To help forestall stakeholder confusion and frustration regarding the applicability of statutory and executive guidance to tax-related regulations, we recommended that the Secretary of the Treasury direct that—when such guidance is not applicable—the text accompanying the publication of proposed and final regulations should contain a complete explanation of why this is so. We also recommended that the Secretary require that regulation drafters document internally, when time constraints permit, their consideration of the factors provided in such statutory and executive guidance to better ensure that tax regulations reflect stakeholders' needs. To maximize the value of informal communications with stakeholders, we recommended that the Secretary encourage regulation drafters to meet with selected stakeholders to work through implementation issues associated with draft-tax regulations before publishing the regulations for notice and comment.

To better ensure that a well-informed basis exists for Treasury and IRS officials to make judgments concerning whether simple, yet effective, regulations have been designed, we recommended that the Secretary of the Treasury require regulation drafters to develop key measures of simplicity for tax regulations. Officials should use these measures to help judge whether existing regulations are too complex and whether regulations under development are sufficiently simple.

Action(s) Taken and/or Pending

In response to our recommendations, IRS reported in March 1995 that it was (1) considering revising the statements contained in the preamble of IRS regulations to more explicitly state its assessment of the applicability of statutory and executive guidance, (2) considering revising procedures for internal documentation to better ensure that tax regulations reflect both the policy choices of Congress and IRS stakeholders' needs, and (3) reviewing its attempts to measure simplicity in conjunction with other significant policy concerns in the promulgation of regulations. IRS also identified three potential opportunities for further improvement: (1) where time and circumstances permit, it will provide a 90-day period for the submission of public comments, and it will consider comments received even after that date, when time permits; (2) it intends to implement a policy of issuing a "plain language" summary of the regulation together with the formal notice of proposed rulemaking and make the summary available through a broader range of media; and (3) it is considering the feasibility of holding public hearings on certain regulations outside Washington, D.C. As of December 31, 1995, IRS had taken no further action on these recommendations, according to an IRS official.

Related GAO Product(s)

GAO/GGD-90-102, 07/31/90 and GAO/GGD-94-105, 04/27/94

Administrative Improvements Possible in IRS' Installment Agreement Program

GAO/GGD-95-137, 05/02/95

At the request of the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we reviewed IRS' use of installment agreements as a means for individual taxpayers to pay their tax debts. IRS changed the guidelines for installment agreements in April 1992 to streamline the process for taxpayers to request installment agreements and for IRS to approve them.

We reported that participation in IRS' installment agreement program grew rapidly after the guidelines were revised—from 1.1 million new agreements for individual taxpayers in fiscal year 1991 to 2.6 million new agreements in fiscal year 1994, an increase of 136 percent. Also, during fiscal years 1991 through 1994, the amount of taxes being paid in new installment agreements increased 135 percent—from $4.0 billion to $9.4 billion. And, installment agreements accounted for 33 percent ($4.5 billion) of IRS' delinquent tax collections from individual taxpayers in fiscal year 1994 compared with 14 percent ($1.9 billion) in fiscal year 1991.

The changes IRS made to its installment agreement procedures affected its collection activities in several ways. First, IRS service center collection and district office taxpayer service staff approved more agreements than in the past. Staff at IRS' Automated Collection System call sites, who previously approved the majority of installment agreements, are now assigned higher-dollar cases. Second, more past due taxes are being paid off in installments without going through IRS' routine collection process. This is due in part because, under IRS' revised procedures, taxpayers can request an installment agreement when they file a balance due tax return.

IRS' internal auditors raised concerns in September 1994 about the ease with which taxpayers can enter into installment agreements. The auditors reported that IRS' new installment agreement procedures may be allowing taxpayers to (1) choose installment agreements to pay their taxes when they could have fully paid their taxes on time and (2) accumulate tax debt because it is easy to add subsequent income taxes to an existing installment agreement. An IRS task group, established in response to the auditors' concerns, made recommendations aimed at reducing the use of installment agreements to accumulate debt that could be paid through other methods. IRS also agreed to test an internal audit recommendation to obtain selected information from program participants on the circumstances causing their tax debt situation.

We reported that IRS informs taxpayers that applicable penalties and interest charges will be added to their installment agreements; however, taxpayers are not given dollar estimates for these penalties and interest. This contrasts with installment agreements made in the private sector, such as those for automobile loans, which typically disclose information regarding terms, conditions, and costs.

Further, mailing costs could be reduced if IRS used regular mail instead of certified mail for routine defaulted installment agreements, which are not subject to levy action. Such agreements are usually placed in deferred status where future collection action is generally limited to periodic notices and offsets against future refunds.

Recommendation(s) to IRS

To improve the information provided to taxpayers and the administration of the installment agreement program, we recommended that the Commissioner of Internal Revenue (1) notify taxpayers about projected total costs and payoff periods when setting up agreements with taxpayers and when mailing monthly reminder notices, (2) experiment with Form 9465, Installment Agreement Request, to test whether having space for taxpayers to authorize direct debit installment payments increases the frequency with which this option is used, and (3) send agreement default notices to taxpayers by regular mail instead of certified mail unless an account is being referred for levy action.

Action(s) Taken and/or Pending

IRS agreed to study the feasibility of notifying taxpayers about total costs and payoff periods of installment agreements. If the notification is not feasible under existing computer systems, IRS said it would pursue changes as part of its TSM program. As an interim step, IRS is planning to break out penalty and interest costs on monthly reminder notices to taxpayers beginning in 1996.

IRS also agreed to make the necessary changes to Form 9465 and to determine the requirements for OMB approval of the new form. Once approved, IRS will test the revised form for increased direct debit usage.

IRS agreed with the recommendation concerning the use of regular mail for default notices and will identify the program changes necessary for implementation.

Related GAO Product(s)

GAO/GGD-95-58R, 12/15/94

IRS Could Do More to Verify Taxpayer Identities

GAO/GGD-95-148, 08/30/95

This report, prepared under our basic legislative authority, discusses IRS' procedures for processing and posting tax returns in which the primary filer did not provide an SSN or provided a name and SSN that did not match Social Security Administration (SSA) records. This report discusses (1) the growth in accounts with missing or incorrect SSNs on IRS' IMF, (2) IRS' procedures for verifying the identities of tax return filers, and (3) the potential effects of the procedures on IRS' plans to modernize the tax system and on IRS' income-matching program.

IRS relies on data from SSA to determine the accuracy of SSNs and names recorded on tax documents submitted by individual taxpayers. IRS uses this information to establish the identity of each taxpayer and to ensure that each transaction is posted to the correct account on the IMF. When processing paper tax returns with missing or incorrect SSNs, IRS service centers first try to make corrections by researching IRS files or other documents (for example, Form W-2 wage and tax statements) that accompany a tax return. Returns that can be corrected, along with those that match SSA records, are posted to the "valid" segment of the IMF. Returns that cannot be corrected are posted to the "invalid" segment of the IMF, using either the incorrect SSN on the tax return or a temporary number assigned by IRS. As of January 1, 1995, 4.3 million accounts were posted on the invalid segment of the IMF, and 153.3 million accounts were posted on the valid segment.

As part of its efforts to combat potential refund fraud, IRS revised its procedures in 1995 to require that taxpayers who file returns with (1) missing or incorrect SSNs or (2) temporary numbers provide documentation to verify their identities. The notice IRS was sending to filers in 1995 (known as the CP54B notice), however, did not clearly convey that they were required to provide documentation to verify their identities.

At the time of our review, IRS was not planning to apply the revised documentation requirements to filers with prior accounts on the IMF invalid segment who file again using the same name and SSN combination. The accounts of these filers, whose identities IRS verified using pre-1995 procedures, were coded to automatically issue a refund when one is requested on a return. As of January 1, 1995, at least 3.2 million accounts on the IMF invalid segment were so coded. We analyzed 58 returns that were posted to the IMF invalid segment in the first 6 months of 1994 and that had accounts coded for automatic refund issuance. Our results suggested that IRS should subject these filers to the revised documentation requirements; 27 of the returns were filed by persons who either used SSNs not issued by SSA or used another individual's SSN, including the SSNs of children or deceased persons.

Developing complete and accurate account information on every taxpayer and being able to respond accurately to taxpayer account inquiries are goals IRS hopes to achieve in its tax system modernization efforts. Achieving these goals is jeopardized by the current master file structure, which allows two or more taxpayers to have accounts under the same number or one taxpayer to have several accounts under different numbers.

IRS' income-matching program is also hampered by posting returns to the IMF invalid segment. IRS matches the income claimed by taxpayers with the income reported by third parties on information returns. Discrepancies are used by IRS to detect underreported income or nonfiling of tax returns.

Recommendation(s) to IRS

To improve the processing of returns with missing or incorrect SSNs and help clean up accounts currently posted on the IMF invalid segment, we recommended that the Commissioner of Internal Revenue

- finalize the CP54B notice in time for use during the 1996 tax filing season and
- apply the revised documentation requirements to taxpayers who filed tax returns that were posted to the IMF invalid segment before 1995 and whose accounts had a permanent refund release code.

Action(s) Taken and/or Pending

IRS officials agreed that a revised CP54B notice was needed and assured us that revised notices would be available for use during the 1996 filing season. With respect to our second recommendation, IRS officials said that a task force was determining the best way to verify accounts placed on the IMF invalid segment before 1995. The task force was also working to reverse the permanent refund release code on the IMF invalid segment accounts that were established before 1995. Further, IRS officials plan to remove IMF invalid segment accounts that have been inactive for a certain period, similar to the treatment of accounts on the valid segment.

Related GAO Product(s)

GAO/GGD-95-6, 12/07/94

Sole Proprietor Identification Numbers Can Be Improved

GAO/GGD-95-160, 09/18/95

Taxpayers are required to have identification numbers so that IRS can establish accounts for them and record transactions such as the payment of taxes. Most taxpayers are required to have only one identification number. However, individuals who are self-employed (i.e, sole proprietors) are sometimes required to have two identification numbers, an SSN for their individual income tax returns and an Employer Identification Number (EIN) for their business returns. This report, to the Joint Committee on Taxation, discussed whether IRS (1) accurately cross-referenced the two identification numbers that self-employed individuals report and (2) needed to take any actions to improve the accuracy of its cross-reference files.

IRS records a sole proprietor's identification numbers on three computer files. It uses the SSN to establish an account on the IMF and includes the EIN in the account for cross-referencing purposes. It uses the EIN to establish an account on the BMF and adds the SSN as a cross-reference. It uses cross-referenced SSNs and EINs from the two master files to build the Cross-Reference Entity File (CREF), which is a file IRS created expressly to consolidate income information on sole proprietors for use in its underreporter program.

We concluded that IRS had not screened out all erroneous identification numbers, which meant that numbers posted to sole proprietors' records as cross-references may identify someone other than the intended taxpayer. From work at the Fresno Service Center, we made the following estimates:

- About 20 percent of the EINs posted to tax year 1991 records on the IMF from Schedule C returns filed at the Fresno Service Center were erroneous.
- About 3 percent of the BMF records of sole proprietors who filed 1991 Schedule C returns with the Fresno Service Center contained inappropriate SSNs as cross-references.
- About 10 percent of the accounts on the CREF that related to 1991 returns filed with Fresno contained erroneous cross-referenced taxpayer identification numbers.

We believe that before posting, IRS did not screen EINs to detect those incorrectly reported on Schedule C. No data were available to discern the total effects of such misposting; however, several false underreporter cases were created at the Fresno Service Center because of erroneous cross-references. More screening is also needed if IRS is to properly integrate a taxpayer's various records under its TSM program.

We found that IRS' difficulties in cross-referencing a sole proprietor's two identification numbers would be eliminated if sole proprietors used a single identification number for all tax information. In addition to aiding IRS, the use of a single identification number would lessen the compliance burden that sole proprietors shoulder, which would be in keeping with IRS authority to require taxpayer identification numbers.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue (1) establish returns-processing and compliance-screening procedures to help remove erroneous cross-referenced taxpayer identification numbers from sole proprietors' tax records and (2) evaluate the feasibility of eliminating the requirement that sole proprietors use EINs for filing business returns.

Action(s) Taken and/or Pending

IRS officials generally agreed that data on the CREF should be perfected and said that IRS would begin evaluating how to do this. They also said that a single taxpayer identification number such as the SSN would facilitate reporting compliance by sole proprietors. IRS officials, however, said that IRS would not pursue such a change because of major implementation obstacles, such as (1) the necessity of extensive reprogramming of IRS, SSA, and private record systems; (2) imposing the added burden on the majority of sole proprietors who now report correctly of changing their reporting responsibilities; (3) requiring sole proprietors to disclose their SSNs on Forms W-2, which raises privacy concerns; and (4) allocating significant IRS resources to educate taxpayers in the new requirement.

We believe that eliminating the EIN requirement for sole proprietors is worthy of further evaluation before a decision is made on its feasibility and cost-effectiveness, especially since in the past IRS allowed sole proprietors to use their SSNs as EINs. A similar policy for those cases where IRS had not assigned an EIN with the same digits as the sole proprietor's SSN should not involve major BMF reprogramming and reconfiguration. IRS is proposing to do a study on the extent of the problems with the CREF and ways to address them. This study could also include an evaluation of the feasibility of sole proprietors using their SSN rather than an EIN.

Related GAO Product(s)

GAO/T-GGD-87-4, 03/17/87; GAO/GGD-94-175, 08/02/94; and GAO/GGD-95-59, 12/28/94

Other

College Savings: Using EE Savings Bonds and Loans From Thrift Savings Plan to Pay for College

GAO/HEHS-95-16R, 11/04/94

Pursuant to a request from Senators Thad Cochran, James M. Jeffords, and Nancy Landon Kassebaum, we reported on ways the federal government can encourage families to save money for their children's college educations. Specifically, we examined (1) whether series EE savings bonds encourage net savings for college and (2) the nonrepayment rate for federal employees who have borrowed from the Thrift Savings Plan (TSP) for education expenses.

With the Technical and Miscellaneous Revenue Act of 1988, Congress created a new federal income tax advantage for using EE savings bonds to pay for certain higher education expenses. For savings bonds purchased in 1990 or later, taxpayers may deduct from their gross income the interest earned on bonds used to pay for tuition and required fees, net of scholarships, at accredited colleges and universities. Few people have used the education expenses provision of series EE savings bonds to pay for college costs. The limited response may be attributable to (1) the fact that investors hold savings bonds generally for an average of 10 years before redeeming them and (2) a 1992 national market survey done for the Department of the Treasury found 77 percent of the respondents had never heard of these special education savings bonds.

Since 1988, federal employees have been able to borrow from their TSP accounts to pay for certain educational expenses. If active federal employees fail to repay their loans on time, a taxable distribution is declared, that is, the amount of unpaid principal and interest is reported to IRS as taxable income received by the borrower. Very few TSP education loans issued from 1988 to 1993 have resulted in taxable distributions—less than 1 percent for active federal employees. For federal employees terminating employment early, regardless of the reason, less than 8 percent had taxable distributions for the period 1988 and 1989. Overall, for this period, over 90 percent of the education loans were repaid in full.

Related GAO Product(s)

GAO/HEHS-95-131, 08/03/95

IRS User Fees

GAO/GGD-95-58R, 12/15/94

Pursuant to a legislative directive, we reviewed the fee structure and methodology used by IRS in developing user fees to ensure that the proposed fees reflected no more than actual costs. At the time of our review, IRS had increased an existing fee—for copying taxpayers' tax records—and proposed three new ones—one related to the electronic tax filing program and two related to the installment agreement program.

We reported that IRS does not presently have a cost-accounting system, and IRS officials told us that the proposed user fees were based on their best estimates of full costs as required by the prevailing OMB guidance. Further, given the limited cost data available to IRS, we could not validate that the proposed fees reflected no more than actual costs.

We noted that IRS is developing an activity-based costing system, which should give it the capability to develop more comprehensive cost information for all activities. The lack of specific data available to IRS in developing the proposed user fees underscores the need for the timely completion of IRS' cost system.

Related GAO Product(s)

GAO/GGD-95-137, 05/02/95

U.S. Insular Areas' Fiscal Relations With the Federal Government

GAO/T-GGD-95-71, 01/31/95

In anticipation of possible new tax and welfare initiatives, the Subcommittee on Native American and Insular Affairs, House Committee on Resources, asked us to provide information on the various fiscal arrangements between the United States and five insular areas: American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. We provided information on (1) income and other tax rules and revenues that apply to these areas, (2) current federal expenditures, and (3) the extent to which they receive major federal social programs.

We testified that individuals who are residents of a territory and who earn income only from sources within the territory owe no federal tax on this income. U.S.-source income is treated differently for federal tax purposes, depending on the territory in which the individual resides. Corporations organized in the territories are generally treated as foreign corporations for U.S. tax purposes and are taxed on their U.S. earnings but not their territorial income. U.S. corporations with subsidiaries in the territories can receive significant tax benefits through the possession's tax credit if certain qualifications are met. The Department of the Treasury estimated these benefits to be about $3 billion annually. Other federal taxes include payroll taxes to fund Social Security and Medicare and excise taxes.

In fiscal year 1993, federal expenditures in the five territories totaled $10.3 billion. The largest expenditure category was "direct payments to individuals." These expenditures were made mostly through Social Security benefits, Medicare benefits, unemployment compensation, and student education grants. Major federal social programs, such as Food Stamps and AFDC, also have been extended in varying degrees to the territories. About 86 percent of the $10.3 billion went to Puerto Rico, which is, by far, the largest possession.

Related GAO Product(s)

GAO/GGD-90-21, 12/08/89; GAO/HRD-91-18, 06/20/91; GAO/NSIAD-92-64, 04/07/92; GAO/GGD-92-72BR, 05/04/92; GAO/RCED-92-114, 07/21/92; GAO/GGD-93-109, 06/08/93; and GAO/NSIAD-94-62, 02/07/94

1994 Annual Report on GAO's Tax-Related Work

GAO/GGD-95-66, 02/16/95

This summary, prepared in compliance with a legislative requirement, 26 U.S.C. 6103(i)(7)(A), contained information on our tax policy and administration-related work during fiscal year 1994. It included (1) summaries of tax-related products issued in fiscal year 1994; (2) summaries of tax-related products issued before fiscal year 1994 with open recommendations to Congress; (3) descriptions of legislative actions taken in fiscal year 1994 in response to our recommendations; (4) a listing of recommendations to Congress that were open as of December 31, 1994; (5) a listing of recommendations we made in fiscal year 1994 to the Commissioner of Internal Revenue; and (6) brief descriptions of assignments for which we were authorized access to tax data in fiscal year 1994 under the above citation.

Addressing the Budget Deficit

GAO/OCG-95-2, 03/15/95

In a report to Congress, we stressed the urgent need for deficit reduction. This report identified the budgetary implications of selected policy changes and program reforms discussed in our work but were not yet implemented or enacted. The report presented 120 options of which 14 fell under "receipts" and were thus tax related. The options were presented in narrative descriptions. They presented ways to address, in a budgetary context, some of the significant problems identified in our evaluations of federal policies and programs. We also presented an analytical framework to provide a structure for congressional consideration of individual options. In some discussions, we provided recommendations. The 14 tax-related options were

- tax treatment of health insurance premiums,
- information reporting on forgiven debts,
- administration of the tax deduction for real estate taxes,
- corporate tax document matching,
- tax treatment of interest earned on life insurance policies and deferred annuities,
- federal agency reporting to the IRS,
- independent contractor tax compliance,
- deductibility of home equity loan interest,
- IRS staff utilization,
- collecting gasoline excise taxes,
- computing excise tax bases,
- small-issue industrial development bonds and qualified mortgage bonds,
- improving compliance of sole proprietors, and
- increasing highway user fees on heavy trucks.

Related GAO Product(s)

GAO/RCED-88-111, 03/28/88; GAO/RCED-88-190BR, 06/27/88; GAO/GGD-89-52, 05/09/89; GAO/GGD-90-31, 01/29/90; GAO/RCED-90-117, 09/26/90; GAO/GGD-90-123, 09/27/90; GAO/GGD-91-94, 08/28/91; GAO/GGD-91-118, 09/27/91; GAO/GGD-92-6, 03/26/92; GAO/GGD-92-43, 04/07/92; GAO/GGD-92-67, 05/12/92; GAO/GGD-92-108, 07/23/92; GAO/GGD-93-130, 09/22/92; GAO/HR-93-13, 12/92; GAO/GGD-93-43, 01/19/93; GAO/GGD-93-42, 02/17/93; GAO/GGD-93-63, 03/25/93; GAO/RCED-93-106, 04/22/93; GAO/GGD-93-97, 05/05/93; GAO/GGD-93-67, 05/11/93; GAO/RCED-94-181, 06/07/94; and GAO/GGD-94-175, 08/02/94

Experience With the Corporate Alternative Minimum Tax

GAO/GGD-95-88, 04/03/95

In a report to Congressman William J. Coyne, we discussed the number, size, and industry class of corporations that paid the corporate AMT over the period 1987 through 1992; why they were liable for it; whether AMT achieved its purpose; and how AMT might affect corporate investment. AMT was substantially revised by Congress in 1986 to ensure that corporations with substantial economic income could not avoid significant tax liability by using exclusions, deductions, and credits. In addition, Congress made changes so that corporations that reported significant income on their financial statements would pay some tax in that year.

Many of the tax preferences that AMT is designed to limit defer tax liability rather than permanently reduce tax. For this reason, AMT is designed to result in the prepayment of tax rather than cause a permanent increase in tax liability. To achieve this, corporations that pay AMT in a particular year may be able to recoup this amount in later years through AMT credit. AMT accelerated tax payments of $27.4 billion over the 1987 through 1992 tax years. Over the same period, corporations used AMT credits totaling $5.8 billion.

Most AMT revenues came from relatively few corporations, but many more corporations bear some burden in complying with AMT provisions. For example, of the universe of 2.1 million corporations subject to AMT, just 2,000 large corporations (or 0.1 percent) paid 85 percent of AMT payments in 1992, and only 28,000 (or 1.3 percent) paid any AMT at all. However, 400,000 corporations filed AMT forms.

AMT most affected corporations and industries that use the exclusions, deductions, and credits that AMT was designed to offset. Of the many rules that make up the AMT, two provisions clearly led to the largest increase in corporations' taxable incomes. These were the provision related to the amount corporations could deduct for the depreciation of assets and the provision that reflects the difference between the amount of income corporations report for tax purposes and the amount they report to shareholders on financial statements.

AMT partially achieved its objective of making corporations with positive economic income pay tax. AMT achieved its second objective by causing corporations that reported positive amounts of book income in a particular year to pay some tax in that year. In every year in the 1987 through 1992 period, at least 6,000 corporations with positive book income that paid no regular tax paid some AMT.

The effects of AMT on corporate investment are not clear. The economic literature that we reviewed indicates that under some circumstances AMT can reduce the incentive for corporations to invest, but under other circumstances, the incentive to invest may be greater under the AMT.

Furthermore, there is not a consensus on the extent that changes in the incentive to invest lead to changes in actual investment. To date, no study has directly tested the extent to which AMT actually affected investments.

Related GAO Product(s)

GAO/T-GGD-95-42, 12/09/94

Paid Tax Preparers and Tax Software

GAO/GGD-95-125R, 04/14/95

In a letter to the Commissioner of Internal Revenue, we shared the results from a limited study of IRS' oversight of both paid preparers of tax returns and software for preparing returns. We found that although paid preparers and tax software may affect tax compliance, IRS lacks data on their compliance impacts.

Paid preparers did about half of the 1992 individual income tax returns. However, IRS does not know the extent to which paid preparers as a whole or by component group caused noncompliance or improved compliance on the returns. IRS' most recent compliance data indicated that in 1988 individual returns done by paid preparers had more noncompliance than all other returns. IRS found noncompliance on about 55 percent of the returns done by paid preparers, compared with about 40 percent on other returns. Knowing the impacts of paid preparers on compliance, particularly by type of paid preparer, can be important given the difference in IRS' oversight. Specifically, IRS imposes more requirements and can impose more sanctions against preparers such as attorneys and certified public accountants who maintain certain professional standards and are qualified to represent clients before IRS, than against unenrolled preparers such as commercial preparers who are not subject to the same professional standards and are not qualified to practice before IRS.

IRS also has limited information on the extent to which taxpayers and preparers use software packages for substitute returns or to which these packages generate accurate returns. The use of tax software in preparing returns is growing. Members of the preparer community have estimated that 80 percent or more of the paid preparers also used tax software. Three basic software options are available: (1) 1040PC software, generating a machine readable return; (2) electronic filing (ELF) software; and (3) other tax software, generating a substitute Form 1040. About 18 million of 116 million returns filed in 1994 used ELF and 1040PC software.

IRS checked all three software options for conformity to specifications and did additional testing on the ELF and 1040PC software. However, IRS did not test whether the software consistently calculated the correct tax liability. Knowing the accuracy of returns prepared using any computer software could be important as IRS strives for 90-percent tax compliance by 2001.

College Savings: Information on State Tuition Prepayment Programs

GAO/HEHS-95-131, 08/03/95

Pursuant to a request from Senators Thad Cochran, James M. Jeffords, and Nancy Landon Kassebaum, we provided information on state tuition prepayment programs, focusing on (1) how these programs operate and the participation rates they have achieved, (2) participants' income levels and options for increasing the participation of lower-income families, and (3) the key issues surrounding these programs.

Several states, following Michigan's lead, have authorized tuition prepayment programs, that allow parents to pay in advance for tuition at participating colleges on behalf of a designated child and guaranteeing to cover the child's future tuition bill at one of these colleges, no matter how much costs rise. By allowing purchasers to "lock in" today's prices, these programs are intended to ease families' concerns about whether they will have enough money in the future to pay for their children's college expenses.

We reported that (1) while none of the seven implemented state programs has achieved an average annual participation rate that seems very high, the programs vary widely among the states; (2) program officials identified several factors as important for maximizing participation—advertising and marketing, a positive public perception of the program, program simplicity and flexibility, and affordably priced benefits; (3) most participants in state tuition prepayment programs come from middle- and upper-income families; (4) program officials considered sliding-scale fees and tax credits poor options for increasing lower-income participation; and (5) some of the major issues concerning the state tuition prepayment programs are the potential effects they may have on students' educational choices, their appeal to middle- and upper-income families, their value as an investment for purchasers, and the degree of risk they pose for states.

The most significant issue facing states in establishing and operating a tuition prepayment program, however, is the possible applicability of federal tax provisions to purchasers, beneficiaries, and the programs themselves. This is important because certain tax consequences could make it more difficult for programs to survive. Concerns about taxation have led some states to defer implementation of their programs.

Officials are most concerned about two potential consequences. First, officials hope these programs are exempt from federal taxes on their investment earnings because paying such taxes makes it more difficult to meet future liabilities. What it takes to qualify as exempt, however, is somewhat unclear, in part because IRS and a federal appeals court have disagreed on the tax status of Michigan's program and also because other existing programs have not received IRS guidance.

Second, program officials are concerned that IRS may decide that purchasers or beneficiaries are liable for federal income taxes annually on the imputed interest earned from their investments in prepaid tuition benefits. Officials have been following guidance IRS issued for Michigan's program, which said that beneficiaries are liable for taxes on the increased value of their prepaid benefits at the time of redemption. Officials are concerned that changing from a deferred to an annual tax would create an administrative burden for their programs and perhaps a disincentive for potential purchasers.

Related GAO Product(s)

GAO/HEHS-95-16R, 11/04/95

Summaries of Tax-Related Products Issued Before Fiscal Year 1995 With Open Recommendations to Congress as of December 31, 1995

Congressional tax-writing committees should explore, within the existing framework, opportunities to exercise more scrutiny over indirect spending through tax expenditures. Congress could also consider integrating tax expenditures into current budget processes so that congressional consideration of a savings target is part of the annual budget process and to ensure that Congress addresses tax expenditures periodically.	76
Congress should consider amending section 7122 of the Internal Revenue Code to remove the requirement that the Treasury General Counsel or his delegate review all offers in compromise of $500 or more and widen IRS' discretionary authority to decide which offers require review.	78
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Congress may want to consider legislation that would require states to send IRS and taxpayers an annual information return on any cash rebates for real estate tax payments.	83
Congress needs to (1) clarify the rules for classifying workers by amending the law to exclude from the common-law definition of "employee" certain classes of workers and (2) consider legislation to improve independent contractor compliance through withholding and/or improved information reporting.	85

Open Recommendation

The tax-writing committees should explore, within the existing framework, opportunities to exercise more scrutiny over indirect spending through tax expenditures. Congress could also consider integrating tax expenditures into current budget processes so that congressional consideration of a savings target is part of the annual budget process and to ensure that Congress addresses tax expenditures periodically (GAO/GGD/AIMD-94-122, 06/03/94).

Summary

At a time when the federal government faces hard choices to reduce the deficit and use available resources wisely, all federal expenditures and subsidies should be carefully reviewed. Tax expenditures or revenues forgone through preferential provisions in the tax code—for example, deductions, exemptions, and credits—can be a useful part of federal policy, but they should be scrutinized. Congressional and executive branch processes do not subject existing tax expenditures to the same controls that apply to programs receiving appropriated funds. This report assessed the growth of federal revenues forgone through income tax expenditures and presented three options for reviewing and controlling their growth: (1) strengthening and extending expenditure control methods now used by congressional tax-writing committees, (2) integrating tax expenditures further into the budget process, and (3) reviewing tax expenditures jointly with related federal outlay programs.

At the request of Representative William J. Coyne, we reviewed tax expenditure growth, focusing on (1) the size of increases in tax expenditures, (2) whether tax expenditures need increased scrutiny, and (3) options that could be used to control the growth of tax expenditures and the advantages and disadvantages of each alternative.

We found that (1) substantial revenues are forgone through tax expenditures, but they do not overtly compete in the annual budget process and most are not subject to reauthorization; (2) policymakers have few opportunities to make explicit comparisons or trade-offs between tax expenditures and federal spending programs; (3) the revenues forgone through tax expenditures reduce the resources available to fund other programs or reduce the deficit and force tax rates to be higher to obtain a given amount of revenue; (4) greater scrutiny of tax expenditures could be achieved by strengthening techniques currently used to control tax expenditures; (5) Congress could further integrate tax expenditures into the budget process by deciding whether savings in tax expenditures are desirable and setting specific savings targets in annual budget resolutions; and (6) reviews of tax expenditures could be integrated with functionally related outlay programs, which could make the government's overall funding effort more efficient.

Recommendation(s) to Congress

We recommended that the tax-writing committees explore, within the existing framework, opportunities to exercise more scrutiny over indirect "spending" through tax expenditures.

If Congress wishes to consider tax expenditure efforts in a broader context of the allocation of federal resources, it could consider further integrating tax expenditures into current budget processes. Providing for congressional consideration of a savings target as part of the annual budget process could ensure that Congress addresses tax expenditures periodically.

Alternatively, options that integrate consideration of related outlay and tax expenditure efforts could promote a more thorough review by the legislative and executive branches of possible trade-offs.

Recommendation(s) to the Office of Management and Budget

Once tax expenditure performance data are developed, we recommended that OMB consult with the Treasury in considering how to portray tax expenditure performance information in the budget. The tax expenditure performance information should be combined with related outlay information to demonstrate the relative efficiency, effectiveness, and equity of federal outlay and tax expenditure efforts within a functional area. Such a presentation could be used to show the relative effectiveness of federal spending programs funded through outlays and tax expenditures.

Action(s) Taken and/or Pending

As a result of our work, examinations of tax expenditures were made part of agency performance plans. Such plans are required by the Government Performance and Results Act. Furthermore, tax expenditures were made part of the congressional budget process when they were incorporated into the 1995 Congressional Budget Resolution as a nonbinding agreement.

Congress has given considerable attention to tax expenditures during the past year. Presidential line-item veto power over selected tax expenditures is included in budget legislation pending as of December 31, 1995. This legislation would permit the President to veto certain targeted tax benefits, including any revenue-losing provision that provides a federal income tax deduction, credit, exclusion, or preference to 100 or fewer tax payers, or certain transition rules that provide a tax benefit to five or fewer taxpayers. The same pending legislation would also create some new tax preferences and expand others, while scaling back, phasing out, or sunsetting others.

Open Recommendation

Congress should consider amending section 7122 of the Internal Revenue Code to remove the requirement that the Treasury General Counsel or his delegate review all offers in compromise of $500 or more and widen IRS' discretionary authority to decide which offers require review (GAO/GGD-94-47, 12/23/93).

Summary

At the request of the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we reviewed IRS' Offer-in-Compromise Program to determine the effect that IRS' new emphasis on the program has had in collecting delinquent taxes and encouraging future compliance.

We reported that IRS was pleased with the initial results of the revised program, but it has yet to demonstrate that the use of offers in compromise will meet the program's overall objectives of increased collections and improved compliance. Although our review of case studies showed that IRS staff followed prescribed procedures in processing taxpayers offers, we identified several things IRS needs to consider as part of its improvement process.

First, IRS needs reliable data on the offer program. IRS uses paper records to track the number of offers received and the amount of tax debt compromised—a process we found subject to error. Once IRS has reliable data, it needs better indicators of the program's effectiveness.

Second, IRS needs to continue to improve the efficiency of the offer program. For example, its recent decision to streamline the processing of offers involving tax debts of less than $10,000 should help reduce administrative costs. At the same time, however, IRS needs to be cautious about overreliance on in-house information sources to substantiate taxpayers' asset claims. In addition, IRS is required by law to obtain a legal opinion on all offers with tax liabilities of $500 or more—a process that increases administrative costs. IRS has proposed raising the review threshold to $50,000. Because the legal complexity of offers is not always directly related to the amount of the tax liability, we believe a better option would be to give IRS discretionary authority to decide when offers need legal review. IRS also relies on time-consuming, manual methods to monitor accepted offers to ensure that taxpayers comply with the conditions of the offer. Automating the monitoring process could improve its efficiency.

Although we had no data to indicate that IRS' increased compromising of tax debts might adversely affect voluntary compliance, we believe IRS needs to be mindful of the effect that settling for less than the full tax liability might have on taxpayers who pay their taxes in full. Congress recognized the potential fairness and equity issues linked to offers in compromise and, as part of the program, required that (1) the names of taxpayers whose debts are compromised, (2) the amount of the debt compromised, and (3) the amount accepted by the government be made public information. IRS might defuse this potential issue if it can demonstrate the overall benefits of the offer program through use of the indicators previously discussed.

Last, IRS needs to determine the causes for variability in offer acceptance rates among district offices. The wide variability in district offices' acceptance rates could raise the question of whether taxpayers are being treated consistently.

Matter(s) for Congressional Consideration

We suggested that Congress consider amending section 7122 of the Internal Revenue Code to remove the requirement that the Treasury General Counsel or his delegate review all offers of $500 or more and widen IRS' discretionary authority to decide which offers require review.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue develop the indicators necessary to evaluate the Offer-in-Compromise Program as a collection and compliance tool. The indicators should be based on accurate data and include (1) the yield of the program in terms of costs expended and amounts collected, (2) the amount of revenues collected that would not have been collected through other collection means, (3) a measure of noncompliant taxpayers who returned to the tax system, and (4) a measure of participating taxpayers who remained compliant in future years.

We also recommended that the Commissioner determine the causes of variability in district office acceptance rates and, where appropriate, take steps to mitigate any inconsistent treatment of taxpayers.

Action(s) Taken and/or Pending

As of December 31, 1995, Congress had taken no action to remove the requirement that the Treasury General Counsel review all offers of $500 or more and to widen IRS' discretionary authority to decide which offers require review.

IRS has begun making changes necessary to gather data to determine program costs. Measuring such costs and yields requires two separate computer programming efforts—one has been completed and the other is part of a broader ongoing effort. IRS has also established a group that will visit selected district offices to conduct interviews and collect data to assist in identifying inconsistencies in the treatment of taxpayers receiving offers in compromise.

Open Recommendation

Congress may wish to consider revising current tax law to allow IRS to use collection performance in determining compensation and rewards for its collection staff as long as other criteria, such as fair and courteous treatment of taxpayers, are also considered (GAO/GGD-93-67, 05/11/93).

Summary

In response to a request by the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we reported on the options available to IRS to enhance its collection of delinquent federal taxes. Specifically, we examined whether IRS could strengthen its tax collection programs by adopting private sector or state collection techniques.

We found that IRS' ability to collect delinquent taxes has been hampered by some self-imposed constraints. For example, IRS has generally followed a lengthy and rigid three-stage collection process that, because of convention, begins with a series of written notices or bills sent to delinquent taxpayers over a period of about 6 months followed by telephone calls and ends with visits to delinquent taxpayers. Further, IRS handles all aspects of delinquent tax collection itself and does not evaluate or reward its collection staff on the basis of collection performance. And, because of inadequate information systems, IRS pursues delinquent accounts without knowing whether the amounts recorded in the accounts are valid receivables and with only limited knowledge about the characteristics of the delinquent taxpayers.

External constraints have also affected IRS' ability to collect delinquent taxes. For example, we found that although IRS and state tax departments currently cooperate in many tax administration projects, only about 10 percent of these projects are directly related to tax collection. IRS may have opportunities for expanding cooperative projects with states that are directly related to collecting delinquent federal taxes. Our survey of states found that more than half of the states with an opinion about participating in joint tax collection projects with IRS would consider engaging in such projects if they were compensated.

We concluded that since IRS competes with private collection companies and state governments for payments from debtors, IRS should adopt collection strategies that are more effective than its current approaches, including (1) early telephone contact with delinquent taxpayers, (2) customized handling of delinquency cases, (3) expanded use of cooperative efforts with state governments, and (4) use of private collection companies.

We also concluded that, for IRS to enhance its collection of delinquent federal taxes, certain external and internal changes would have to occur.

Matter(s) for Congressional Consideration

We continue to believe that Congress may wish to consider revising current tax law to allow IRS to use collection performance in determining compensation and rewards for its collection staff as long as other criteria, such as fair and courteous treatment of taxpayers, are also considered.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue (1) restructure IRS' collection organization to support earlier telephone contact with delinquent taxpayers and determine how to use current collection staff in earlier, more productive phases of the collection cycle; (2) develop detailed information on delinquent taxpayers and use it to customize collection procedures; and (3) identify and implement ways to increase cooperation with state governments in collecting delinquent taxes. We also recommended that the Commissioner allow the Assistant Commissioner (Collection) to use private collection companies, on a test basis, to support IRS' collection efforts as permitted by current law.

Action(s) Taken and/or Pending

In January 1995, IRS implemented a nationwide early intervention collection program to send delinquent taxpayers fewer notices and make telephone contact sooner. The program, involving several hundred employees at multiple locations, aims at sending delinquent individual taxpayers three notices rather than the normal five notices and attempting telephone contact after 2 to 3 months instead of after 6 months. While specific performance data are not yet available, IRS officials contend that the program has been successful. IRS plans other enhancements to its collection process, including using characteristics of the delinquency case to determine the most appropriate collection enforcement action to be pursued to resolve the case. Also, a provision in IRS' fiscal year 1996 appropriations bill directs IRS to devote $13 million to test the use of private collection agencies to locate and contact delinquent taxpayers.

Open Recommendation

Congress should consider enacting legislation that would substitute a residency test for the dependent support test if the dependent lives with the taxpayer. If enacted, Congress also should consider eliminating the household maintenance test for filing as head of household status (GAO/GGD-93-60, 03/19/93).

Summary

In a report to the Chairman, Senate Committee on Finance, we reported on individual compliance in claiming dependent exemptions and filing status. We analyzed IRS' most recent compliance audits of individuals for 1988 to determine the extent and causes of noncompliance and to identify ways to improve compliance. According to IRS' audits, taxpayers erroneously claimed exemptions for an estimated 9 million dependents for 1988, improperly lowering their taxable income by an estimated $17 billion. Also, an estimated 3 million taxpayers claimed the wrong filing status.

According to our estimates, the primary source (73 percent) of erroneous dependent claims for 1988 was the taxpayer's failure to meet the dependent support test. Of those not meeting this test, taxpayers either did not (1) provide the necessary financial support or (2) have adequate records to show whether they provided the support. We found that the support test was complex because it required detailed records and difficult financial analyses. After analyzing four options, we found only one that eliminated the complexity of the support test by replacing it with a residency test. Under this test, taxpayers can claim dependents who lived with them for at least 6 months, if they meet other dependency tests.

If the support test were replaced, complexity would not be reduced for taxpayers claiming head of household filing status. These taxpayers would still have to meet a maintenance test, which is nearly as complex as the support test. IRS data showed that the head of household accounted for an estimated 82 percent of all filing status errors in 1988.

Even if Congress simplified these tests, IRS could do more to detect any remaining erroneous dependent claims. For 1988, IRS matched about 3 percent of dependents' SSNs to identify dependents who were claimed on more than one tax return or did not meet income and age requirements. If IRS had a 100-percent computer-matching program for 1988, IRS could have generated an estimated $751 million in tax revenues at a cost that ranges between $45 million to $60 million. A 100-percent computer-matching program coupled with the simpler rules would address an estimated 4.3 million (71 percent) of the 6.1 million erroneous dependent claims.

Matter(s) for Congressional Consideration

We continue to believe that Congress should consider enacting legislation that would substitute a residency test for the dependent support test if the dependent lives with the taxpayer. If this legislation is enacted, Congress also should consider eliminating the household maintenance test for filing as head of household status.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue correct the operational problems in IRS' limited computer-matching program and implement a 100-percent computer-matching program to identify erroneous dependent claims.

Action(s) Taken and/or Pending

Congress considered such legislation in 1993, but not recently. IRS, in response to our recommendation, is doing a 100-percent computer match for the 1995 filing season. IRS will code and transcribe SSNs for up to four dependents per return. Dependent SSNs not matching the SSA file will "fall out" in the Error Resolution System for further action.

Open Recommendation

Congress may want to consider legislation that would require states to send IRS and taxpayers an annual information return on any cash rebates for real estate tax payments (GAO/GGD-93-43, 01/19/93 and GAO/T-GGD-93-46, 09/21/93).

Summary

In a report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the IRS, Senate Committee on Finance, and in subsequent testimony before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, we discussed the issue of overstated real estate tax deductions among individual taxpayers. We reviewed IRS' random compliance audits of individuals and contacted 171 local governments that collected $100 million or more in real estate taxes.

We found that IRS audits showed individuals overstated their 1988 real estate tax deduction by an estimated $1.5 billion nationwide. This level of noncompliance resulted in an estimated $300 million federal income tax loss for 1988 and about $400 million for 1992. However, we found that the level of noncompliance and resulting tax loss were much greater. IRS audits detected only an estimated $37 million (29 percent) of $127 million in overstated deductions in three locations.

The overstated deductions arose from taxpayers deducting Montgomery County, Maryland, user fees and not reporting New Jersey and Minnesota real estate tax rebates. The reasons for such noncompliance included (1) inadequate IRS instructions on what to deduct or report and (2) confusing real estate tax bills that did not clearly distinguish taxes from user fees.

Matter(s) for Congressional Consideration

We continue to believe that Congress may want to consider legislation that would require states to send IRS and taxpayers an annual information return on any cash rebates for real estate tax payments.

Recommendation(s) to IRS

We recommended that the Commissioner of Internal Revenue (1) include rules on the tax deductibility of user fees and rebates in tax return instructions and consider ways, such as an optional worksheet, to help taxpayers calculate the real estate tax deduction; (2) work cooperatively with local governments to revise their real estate tax bills to identify user fees, label these charges as not tax deductible, and notify taxpayers that the local government may report the deductible tax to IRS; (3) notify examiners to check local records on user fees and state records on rebates to verify real estate tax deductions; and (4) negotiate agreements with local governments on sharing data on real estate tax payments made by individuals and use the data in IRS' enforcement programs.

Action(s) Taken and/or Pending

Regarding the first recommendation to IRS, IRS published an explanation in the 1994 filing year Form 1040 instructions that deductions cannot be taken for itemized charges for services, charges for improvements that increase property value, and refunds or rebates of real estate taxes. IRS also has notified its examiners to better check support for the deduction and has been working with local governments on revisions to their bills. Congress is awaiting the outcome of IRS' work with the local governments before considering the need for any legislation.

Open Recommendation

Congress needs to (1) clarify the rules for classifying workers by amending the law to exclude from the common-law definition of "employee" certain classes of workers and (2) consider legislation to improve independent contractor compliance through withholding and/or improved information reporting (GAO/GGD-92-108, 07/23/92 and GAO/T-GGD-92-63, 07/23/92).

Summary

At the request of Senators Max S. Baucus and David H. Pryor and Congressman Doug Barnard, Jr., we reviewed the tax effects of IRS' Employment Tax Examination Program (ETEP). This program focuses on small business compliance with the common-law rules for classifying workers as either "employees" or "independent contractors" (self-employed individuals who provide services).

We issued a report and testified at a hearing before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means. We said the common-law rules for classifying workers remain unclear and subject to conflicting interpretations as we had described in our report entitled Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions (GGD-77-88, Nov. 21, 1977). Since then, no final action has been taken to clarify the common-law rule.

We also reported that independent contractor compliance continued to be a concern. In 1979, we concluded that noncompliance among self-employed workers, such as independent contractors, was serious enough to warrant tax withholding on payments to them. Since the mid-1970s, IRS studies have documented the lower level of compliance of independent contractors compared with employees. IRS estimated that self-employed individuals (including independent contractors) would underpay $20.3 billion in 1992 taxes by not reporting income.

Because of the continual high tax noncompliance of independent contractors, IRS began the nationwide ETEP in 1988. IRS planned to reduce this noncompliance by requiring businesses to treat misclassified independent contractors as employees subject to withholding taxes. We reported that 6,900 ETEP audits through December 1991 proposed assessments of $468 million and reclassified 338,000 workers as employees. Since fiscal year 1989, IRS data have shown that 90 percent of ETEP audits have found misclassified workers.

We found that while the classification rules still need clarifying, IRS could use approaches in addition to ETEP to help improve independent contractor compliance. For example, IRS could require businesses to (1) withhold taxes from payments to independent contractors and (2) improve compliance in filing information returns on payments to independent contractors. We concluded that either approach should help collect more of the taxes owed through means other than retroactive tax assessments under ETEP. While we acknowledged that both approaches would increase the burden on independent contractors and businesses that use them, we believed that both approaches had merit.

We reported on the pros and cons of each approach. For example, we said withholding provides the cornerstone of employees' tax compliance as well as a gradual and systematic method to pay taxes. We also reported that withholding has several administrative problems that need to be resolved, such as ensuring that the tax withheld approximates the tax due.

Our second approach—improving information reporting—would shift emphasis to the clearer laws on information returns. IRS' data show that independent contractors reported 97 percent of the income that appears on information returns. Without these returns, contractors reported only 83 percent. We assessed eight options for strengthening information reporting and itemizing the various pros and cons of each, which we had identified in past and ongoing work.

Recommendation(s) to Congress

We recommended that Congress clarify the rules for classifying workers along the lines that we recommended in our 1977 report by amending the law to exclude certain classes of workers from the common-law definition of "employee." We also recommended that Congress consider legislation to improve independent contractor compliance through withholding and/or improved information reporting.

Action(s) Taken and/or Pending

As of December 31, 1995, Congress had considered but had not enacted either of our recommendations. Tax-writing committees are expected to resume debate on this issue in 1996.

Listing of Open Recommendations to Congress Before and During Fiscal Year 1995

Congress should amend the Internal Revenue Code to allow IRS to provide information to all responsible officers regarding its efforts to collect the trust fund recovery penalty from other responsible officers. 35

Congress may want to provide for reviewing the fixed base of the revised research tax credit periodically and adjusting it as needed to prevent it from becoming too generous or too restrictive over time. 47

Congress may want to consider amending federal legislation to (1) authorize states to offset current recipients' benefits without client consent to recover Food Stamp overpayments caused by agency error and (2) extend the authority for states to intercept federal income tax refunds to include the recovery of AFDC and Medicaid overpayments. 49

Congressional tax-writing committees should explore, within the existing framework, opportunities to exercise more scrutiny over indirect spending through tax expenditures. Congress could also consider integrating tax expenditures into current budget processes so that congressional consideration of a savings target is part of the annual budget process and to ensure that Congress addresses tax expenditures periodically. 76

Congress should consider amending section 7122 of the Internal Revenue Code to remove the requirement that the Treasury General Counsel or his delegate review all offers in compromise of $500 or more and widen IRS' discretionary authority to decide which offers require review. 78

Congress may wish to consider revising current tax law to allow IRS to use collection performance in determining compensation and rewards for its collection staff as long as other criteria, such as fair and courteous treatment of taxpayers, are also considered. 80

Congress should consider enacting legislation that would substitute a residency test for the dependent support test if the dependent lives with the taxpayer; if enacted, Congress also should consider eliminating the household maintenance test for filing as head of household status. 82

Congress may want to consider legislation that would require states

Listing of Recommendations Made in Fiscal Year 1995 to the Commissioner of Internal Revenue and to Other Agency Heads[1]

Improve Compliance With Tax Laws

(1) Develop plans to modify audit management information systems to more fully reflect the results of partnership audits by including information on tax assessments on partners' income tax returns and changes in allocations of profits/losses among partners; (2) analyze computer partnership files to develop audit leads and select returns for audit; (3) reinstate the delinquency check program for partnerships to identify other partnerships that do not file required tax returns; (4) develop plans for a document-matching program using information returns to verify partnership income; and (5) devise ways to enter all Schedules K-1 onto the computer, so they can be used in the individual computer document-matching program and for other compliance purposes.	29

Assist Taxpayers

Establish a service-wide definition of taxpayer abuse or mistreatment and identify and gather the management information needed to systematically track its nature and extent.	35
Ensure that IRS' systems modernization effort provides the capability to minimize unauthorized employee access to taxpayer information in the computer system that will replace the Integrated Data Retrieval System.	35
Revise the guidelines for Information Gathering Projects to require that specific criteria be established for selecting taxpayers' returns to be examined during each project and to require a separation of duties between those staff members who identify returns with potential for tax changes and those who select the returns to be examined.	35
Reconcile outstanding cash receipts more often than once a year, and stress in forms, notices, and publications that taxpayers should use checks or money orders rather than cash to pay their tax bills.	36

[1]Except where stated otherwise, these recommendations were made to the Commissioner of Internal Revenue.

Better inform taxpayers about their responsibility and potential liability for the trust fund recovery penalty by providing them with special information packets.	36
Seek ways to alleviate taxpayers' frustration in the short term by analyzing the most prevalent kinds of information-handling problems and ensuring that requirements now being developed for new information systems provide for long-term solutions to those problems.	36
Provide specific guidance for IRS employees on how they should handle White House contacts other than those that involve checking taxes of potential appointees or routine administrative matters.	36
Test the feasibility of using IRS' Correspondex computer system to produce Individual Master File (IMF) and Business Master File (BMF) notices and, if possible, transfer as many IMF and BMF notices as practical to the Correspondex system. The notices should be transferred in stages, and the ease of the transition, its costs, and the benefits of making these transfers should all be considered in establishing the order of the transfers.	38
Establish a system to monitor proposed notice text revisions to oversee progress or problems encountered in improving notice clarity. This system should be able to identify when a revision was proposed and its status at all times, and it should contain a threshold beyond which delays must be appropriately followed up and resolved.	39
Help improve forms and publications by making additional efforts to identify the specific concerns of individual taxpayers. Some ways available include (1) soliciting information from IRS field personnel (including auditors, examiners, and customer-service representatives) to identify common errors made by taxpayers that may be related to confusing passages in forms and publications, and (2) gathering information concerning the nature of taxpayer questions received through IRS' toll-free telephone system.	40

Undertake an aggressive effort to (1) identify and define the appropriate telephone assistance program operating practices for IRS that would allow it to optimize the number of calls it can answer within current budget constraints and (2) work with leadership of the employees' union to reach agreement on implementing those practices on a nationwide basis.	43
Take steps to effectively route taxpayers' calls nationwide, using real-time information. These steps could include a combination of acquiring technology for real-time traffic monitoring and management, utilizing the routing capability of IRS' telecommunications vendor, and fully implementing the features of IRS' existing call routing technology.	43

Improve IRS Management

Focus the electronic filing business strategy on a wider population of taxpayers, including taxpayers who can benefit from filing electronically.	52
Implement a process for selecting, prioritizing, controlling, and evaluating the progress and performance of all major information systems investments, including explicit decision criteria.	52
Require that future contractors who develop software for IRS have a software development capability rating of at least Capability Maturity Model-level 2.	52
Address technical infrastructure weaknesses by (1) completing an integrated systems architecture; (2) institutionalizing formal configuration management for all new systems development projects and upgrades and developing a plan to bring ongoing projects under formal configuration management; and (3) developing security concepts of operations, disaster recovery, and contingency plans.	52
Give the Associate Commissioner management and control responsibility for all systems development activities, including those of the IRS research and development division.	53

Implement the software, hardware, and procedural changes needed to create reliable subsidiary accounts receivable and revenue records that are fully integrated with the general ledger. 55

Change the current federal tax-deposit coupon reporting requirements to include detailed reporting for all excise taxes, FICA taxes, and employee withheld income taxes. 54

Implement software changes that will allow detailed taxes reported to be separately maintained in the master file, other related revenue accounting feeder systems, and the general ledger. 55

Improve the Processing of Returns and Receipts

Encourage taxpayers to make address changes by (1) accepting changes of address over the telephone; (2) making Form 8822, Change of Address, more conveniently available; and (3) emphasizing to taxpayers the importance of keeping their addresses current with IRS. 58

Establish a centralized unit within each of IRS' service centers to process all service center undeliverable mail. 58

The Secretary of the Treasury should forestall stakeholder confusion and frustration regarding the applicability of statutory and executive guidance to tax-related regulations by directing that, when such guidance is not applicable, the text accompanying the publication of proposed and final regulations contain a complete explanation of why this is so. 59

The Secretary of the Treasury should require that regulation drafters document internally, when time permits, their consideration of the factors provided in statutory and executive guidance to better ensure that tax regulations reflect stakeholders' needs. 60

The Secretary of the Treasury should encourage regulation drafters to meet with selected stakeholders to work through implementation issues associated with draft-tax regulations before publishing the regulations for notice and comment. 60

The Secretary of the Treasury should require regulation drafters to develop key measures of simplicity for tax regulations that can be used to help judge whether existing or proposed regulations are too complex. 60

Improve the information provided to taxpayers and the administration of the installment agreement program by (1) notifying taxpayers about projected total costs and payoff periods when setting up agreements with taxpayers and when mailing monthly reminder notices; (2) experimenting with Form 9465, Installment Agreement Request, to test whether providing space for taxpayer authorization of direct debit installment payments increases the use of this option; and (3) sending agreement default notices to taxpayers by regular mail instead of certified mail unless an account is being referred for levy action. 62

Improve the processing of returns with missing or incorrect SSNs and help clean up accounts currently posted on the IMF invalid segment by (1) finalizing the CP54B notice for use in the 1996 tax filing season and (2) applying the revised documentation requirements to taxpayers who filed tax returns that were posted to the IMF invalid segment before 1995 and whose accounts had a permanent refund release code. 64

Establish returns-processing and compliance-screening procedures to help remove erroneous cross-referenced taxpayer identification numbers from sole proprietors' tax records. 65

Evaluate the feasibility of eliminating the requirement that sole proprietors use EINs for filing business returns. 65

Chronological Listing of GAO Products on Tax Matters Issued in Fiscal Year 1995

Tax Administration: Continuing Problems Affect Otherwise Successful 1994 Filing Season (GAO/GGD-95-5)	10/07/94
Tax Administration: Earned Income Credit-Data on Noncompliance and Illegal Alien Recipients (GAO/GGD-95-27)	10/25/94
Tax Administration: IRS Can Strengthen Its Efforts to See That Taxpayers Are Treated Properly (GAO/GGD-95-14)	10/26/94
College Savings: Using EE Savings Bonds and Loans From Thrift Savings Plan to Pay for College (GAO/HEHS-95-16R)	11/04/94
Tax Administration: IRS Efforts to Improve Forms and Publications (GAO/GGD-95-34)	12/07/94
Tax Administration: Changes Needed to Reduce Volume and Improve Processing of Undeliverable Mail (GAO/GGD-95-44)	12/07/94
Tax Administration: IRS Notices Can Be Improved (GAO/GGD-95-6)	12/07/94
Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42)	12/09/94
IRS User Fees (GAO/GGD-95-58R)	12/15/94
Tax Administration: Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59)	12/28/94
Tax Administration: Process Used to Revise the Federal Employment Tax Deposit Regulations (GAO/GGD-95-8)	12/29/94
Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39)	12/30/94
U.S. Insular Areas: Information on Fiscal Relations With the Federal Government (GAO/T-GGD-95-71)	01/31/95
Tax Administration: Tax Compliance Initiatives and Delinquent Taxes (GAO/T-GGD-95-74)	02/01/95
Tax Policy and Administration: 1994 Annual Report on GAO's Tax-Related Work (GAO/GGD-95-66)	02/16/95
Tax Systems Modernization: Unmanaged Risks Threaten Success (GAO/T-AIMD-95-86)	02/16/95
Tax Administration: IRS' Fiscal Year 1996 Budget Request and the 1995 Filing Season (GAO/T-GGD-95-97)	02/27/95
Tax-Exempt Organizations: Information on Selected Types of Organizations (GAO/GGD-95-84BR)	02/28/95
High-Risk Series: Internal Revenue Service Receivables (GAO/HR-95-6)	02/95
Information on Tax Liens Imposed by IRS (GAO/GGD-95-87R)	03/03/95
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Tax Administration: Administrative Improvements Possible in IRS' Installment Agreement Program (GAO/GGD-95-137)	05/02/95
Options Reporting to IRS (GAO/GGD-95-145R)	05/05/95
Tax Policy: Additional Information on the Research Tax Credit (GAO/T-GGD-95-161)	05/10/95
Money Laundering: Needed Improvements for Reporting Suspicious Transactions Are Planned (GAO/GGD-95-156)	05/30/95
Reducing the Tax Gap: Results of a GAO-Sponsored Symposium (GAO/GGD-95-157)	06/02/95
Taxpayer Compliance: Reducing the Income Tax Gap (GAO/T-GGD-95-176)	06/06/95
Earned Income Credit: Noncompliance and Potential Eligibility Revisions (GAO/T-GGD-95-179)	06/08/95

(continued)

Tax-Exempt Organizations: Activities and IRS Oversight (GAO/T-GGD-95-183)	06/13/95
Tax Administration: IRS' Partnership Compliance Activities Could Be Improved (GAO/GGD-95-151)	06/16/95
Welfare Benefits: Potential to Recover Hundreds of Millions More in Overpayments (GAO/HEHS-95-111)	06/20/95
Tax-Exempt Organizations: Additional Information on Activities and IRS Oversight (GAO/T-GGD-95-198)	06/29/95
Tax Policy and Administration: California Taxes on Multinational Corporations and Related Federal Issues (GAO/GGD-95-171)	07/11/95
Tax Compliance: 1994 Taxpayer Compliance Measurement Program (GAO/T-GGD-95-207)	07/18/95
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Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed (GAO/AIMD-95-156)	07/26/95
Tax Administration: Issues Involving Worker Classification (GAO/T-GGD-95-224)	08/02/95
College Savings: Information on State Tuition Prepayment Programs (GAO/HEHS-95-131)	08/03/95
Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141)	08/04/95
Tax Administration: IRS Could Do More to Verify Taxpayer Identities (GAO/GGD-95-148)	08/30/95
Tax Administration: Sole Proprietor Identification Numbers Can Be Improved (GAO/GGD-95-160)	09/18/95
Tax Administration: Recurring Issues in Tax Disputes Over Business Expense Deductions (GAO/GGD-95-232)	09/26/95

Listing of Assignments for Which GAO Was Authorized Access to Tax Data in Fiscal Year 1995 Under 26 U.S.C. 6103(i)(7)(a)

Subject Matter	Objectives
Compliance characteristics for other income	To identify (1) the types of income being reported on the other income line and (2) the compliance rate for each type of reported income and, if possible, determine the reasons for the noncompliance.
Examination and Information Returns Program	To determine (1) why the assessment processes currently take so long, (2) what IRS is doing to speed up the assessment processes, and (3) what additional actions IRS can take to further speed up the processes.
Low Income Housing Tax Credit (LIHTC)	To determine (1) how efficiently IRS is administering and monitoring LIHTC, (2) what controls are in place at the state level to ensure that the credit is applied as intended and costs are reasonable, (3) what controls exist to ensure that states do not certify buildings as eligible for the credit beyond the amount allocated by state housing authorities, (4) the characteristics of the individuals residing in the units produced by the credits, and (5) such other issues as may arise during the course of examination.
IRS' Taxpayer Compliance Measurement Program	To (1) monitor testing of IRS' computerized data capture mechanism, (2) evaluate auditor training, (3) review quality review procedures, (4) evaluate the case building techniques and (5) assess IRS' ability to make use of interim data from program audits.
1995 filing season	To (1) assess IRS' performance during the 1995 tax return filing season and (2) review the administration's FY 1996 budget for IRS.
Unrelated Business Income Tax	To update our 1987 study relating to the competition between tax-related organizations and taxable businesses.
Nonwage earners' compliance with income requirements	To (1) review the filing patterns and sources of income of nonwage earners, (2) develop profiles of the taxpayers, (3) provide taxpayer-specific case studies of nonwage earners, (4) review the adequacy of IRS requirements, (5) analyze the accounts receivable inventory attributable to these taxpayers, and (6) develop recommendations to improve tax compliance and collection programs related to nonwage earners.
Impact of revenue officers on collection of overdue taxes	To determine (1) the impact of field collection staff, particularly revenue officers, and (2) whether revenue officers' duties were done efficiently and economically.
IRS' delinquent tax collection	To determine how IRS' delinquent tax collection process can be reengineered or restructured.
IRS' Compliance 2000 effort	To determine how IRS selected, managed, and captured results for Compliance 2000 initiatives and coordinated the initiatives with other enforcement activities.
Audits of large corporations	To determine what factors affect the rate at which taxes recommended by revenue agents get assessed.
Elimination of computer security risks	To determine (1) how IRS restricts access to computer data, systems, and facilities; (2) manages changes to IRS' computer systems software; (3) prepares for disasters and contingencies; and (4) safeguards its communications network against unauthorized access.

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