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The Internal Revenue Service (IRS) and the States routinely exchange large amounts of tax information. The IRS provides the States with Federal audit report abstracts, computer tapes, and tax returns containing confidential information on millions of taxpayers; the States in turn make their tax returns and audit reports available to IRS. This exchange should increase tax revenues, reduce duplicate audits, and increase taxpayer compliance. Findings/Conclusions: The IRS has no formal program for exchanging information with States and devotes relatively little effort to exchange activities. Because of the low priority which IRS has historically given to tax information exchange activities, it and the States have not defined their mutual information needs specifically enough. As a result, States receive much information they do not need or use while IRS does not make available such information that the States could use. The IRS has not taken advantage of such State tax information which could be used to identify nonfilers. Much of the information the States need could be provided on computer tapes on a cost-reimbursable basis, but IRS has been reluctant to do this. Recommendations: The Commissioner of Internal Revenue should: fix managerial responsibility at the national office level with authority to coordinate all aspects of the program; fix responsibility for managing the program at the regional, district, and service center levels; establish formal policies, procedures, and guidelines for implementing, monitoring, and evaluating the program; evaluate each State's need for and use of Federal tax information; tailor magnetic tapes of tax information to the particular needs of each State; develop an implementation plan with each State specifying exact types and amounts of information to be exchanged and the methods

of exchange; require States to provide precise criteria and screen out IRS audit reports which do not meet the criteria; obtain feedback from States on benefits resulting from IRS-supplied information; and notify taxpayers that any change in the Federal tax liability resulting from IRS audit could affect their State tax liability. (RBS)

REPORT BY THE

Comptroller General

OF THE UNITED STATES

Better Management Needed In Exchanging Federal And State Tax Information

IRS and the States routinely exchange large amounts of tax information. But IRS management of these exchange activities is fragmented, unsystematic, uncoordinated, and has been a low priority. Because IRS and the States have not defined their respective information needs specifically enough:

- States often get Federal tax information they do not use while they do not get some information they need.
- IRS is not taking full advantage of available State tax information.

GAO recommends that IRS fix this responsibility so that exchange activities can be effectively managed at the Federal level. GAO also recommends a number of other actions to reduce unnecessary disclosure of Federal tax information, while at the same time increasing benefits to IRS and the States.





COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-137762

To the Chairman and Vice Chairman
Joint Committee on Taxation
Congress of the United States

This report, one of a series in response to your Committee's request, recommends that the Internal Revenue Service (IRS) fix responsibility within IRS to better manage tax exchange activities with the States. It also recommends actions to reduce unnecessary disclosures of Federal tax information while at the same time increasing benefits to IRS and the States. IRS agreed with the substance of our recommendations and has established a task force to determine how to best implement them.

As arranged with your Committee, unless you publicly announce its contents earlier, we plan no further distribution until 30 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.

A handwritten signature in black ink, appearing to read "James P. Steele".

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT
TO THE JOINT COMMITTEE ON
TAXATION
CONGRESS OF THE UNITED STATES

BETTER MANAGEMENT NEEDED
IN EXCHANGING FEDERAL AND
STATE TAX INFORMATION

D I G E S T

The exchange of confidential tax information between the Internal Revenue Service (IRS) and the States is intended to increase tax revenues, reduce duplicate audits, and increase taxpayer compliance.

IRS routinely provides States with Federal audit report abstracts, computer tapes, and tax returns containing confidential information on millions of taxpayers. States, in turn, make available their tax returns and audit reports to IRS.

This exchange program is important. It has benefited IRS and the States and, with improvements, can produce even greater benefits for each. (See pp. 2 to 5.

Although the exchange of tax information is governed by formal agreements, IRS conducts the activities informally, with low priority and without unified direction. No one official or unit has overall responsibility for managing exchange activities. This lack of central management has resulted in an absence of adequate program management and in activities generally being carried out in a fragmented, uncoordinated, and unsystematic manner. The first step for better management is IRS's fixing responsibilities for the program. (See pp. 24 to 29.)

Another step needed is for IRS and States to identify each other's tax information needs. Complete and precise identification of these needs would enable IRS and States to specify tax information which should and should not be exchanged. Identification of needs is the key to the effectiveness of the program.

The Congress has recognized the importance of States receiving Federal tax information. The Tax Reform Act of 1976 stipulates that States adequately safeguard the information

against misuse and unauthorized disclosure. The first safeguard against these potential abuses is to limit States to only that Federal tax information they actually need. But IRS has no formal policy to limit States to only the information they need nor to monitor States' use of information. Such action is needed to protect confidentiality by reducing unnecessary disclosures and helping to prevent unauthorized disclosures. (See pp. 6 and 7.)

States receive much information they do not use. In 1976, for example:

- Forty-seven States received 800,000 IRS audit reports on individual taxpayers but many were not used because the reports did not meet States' minimum dollar criteria or the Federal audit adjustments had no bearing on State tax issues. (See pp. 7 to 9.)
- Forty-one States received IRS's computer tapes--called Individual Master File tapes--containing confidential information on each taxpayer in their respective States. Many States did not use much of this information. (See pp. 10 to 12.)
- Florida copied 216,000 Federal tax returns which represented 41 percent of the 523,000 returns copied by all States. However, Florida used only 26 percent of the returns it copied. (See pp. 12 to 14.)
- New York received 97 percent of the 15,870 tax returns identified for States by IRS as having good audit potential. New York did not use about 20 percent of these returns because of staff cutbacks and because some returns had little audit potential for the State. (See p. 14.)

In other instances, apparently due to the low priority it gives exchange activities, IRS has been lax in granting State requests or in telling States what information is available. For instance, Kentucky, Rhode Island, and Connecticut have requested, but have not received, audits done by IRS service centers.

Rhode Island could also use a computer tape of gift tax information to identify nonfilers of gift tax, but the State was not aware that such information existed. (See pp. 14 to 16.)

Much information States need could be provided on computer tapes--either special tapes or tailored versions of the individual master file tapes--on a cost-reimbursable basis. IRS has been reluctant to do this. However, IRS recently announced that it plans to "tailor" future tapes, to the extent practicable, to meet the needs of individual States. (See pp. 16 and 17.)

IRS has not taken advantage of available State information which could be useful. For instance, in 1976 it did not obtain audit results from 16 States on 445,000 individuals and audit results from 29 States on 280,000 corporate taxpayers. (See pp. 17 to 19.)

IRS could use State information to identify Federal nonfilers. Although most States which receive individual master file tapes could use them to identify Federal nonfilers for IRS, only three States were doing so. IRS has only recently begun to consider how to better use State tax information. (See pp. 19 and 20.)

Another problem is that IRS does not notify taxpayers that their State tax liability may be affected as a result of IRS audit adjustments. (See p. 21.)

RECOMMENDATIONS

GAO recommends that the Commissioner of Internal Revenue:

- Fix managerial responsibility at the national office level with authority to coordinate all aspects of the program.
- Fix responsibility for managing the program at the regional, district, and service center levels.
- Establish formal policies, procedures, and guidelines for implementing, monitoring,

and evaluating the program. This should include a written policy of restricting States to receiving only that Federal tax information they genuinely need and use.

- Completely evaluate each State's need for and use of Federal tax information, as well as IRS's need for State tax information.
- Tailor magnetic tapes of tax information to the particular needs of each State.
- Develop an implementation plan with each State spelling out the exact types and amounts of information to be exchanged and the methods of exchange.
- Require States to provide precise cutoff criteria and screen out, where appropriate, IRS audit reports and tax returns which do not meet the criteria provided.
- Include as part of security reviews at States a determination that Federal tax information provided is actually used and that it is used for tax administration purposes only.
- Obtain feedback from States on additional tax assessments or other benefits resulting from IRS-supplied information.
- Notify taxpayers that any change in their Federal tax liability resulting from IRS audit could affect their State tax liability. (See p. 30.)

IRS's COMMENTS

IRS agreed with the substance of GAO's recommendations and has organized a task force to study them and plan how to carry them out to the maximum practicable extent. IRS also said that once the task force completes its study on June 1, 1978, the results would be sent to GAO and the Joint Committee on Taxation and actions would be taken to correct deficiencies. (See p. 31.)

STATES' COMMENTS

Each of the 15 States GAO discussed in the report commented on the report. None disagreed with the main points of the conclusions and recommendations. Other than the three that primarily had technical comments, the responses ranged as follows:

- Eight generally concurred with the report.
- Three said the report was accurate but expressed certain concerns about it. For example, Minnesota was apprehensive that "foes" of the exchange program could use the report to damage existing Federal-State relations. GAO supports the exchange program.
- Florida disagreed with the finding that excessive Federal tax returns are disclosed to it. However, it took steps in 1978 to reduce the number of Federal returns it copies by 40 to 50 percent. (See pp. 31 to 34.)

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ABBREVIATIONS

DIF	discriminant function
IMF	Individual Master File
IRS	Internal Revenue Service
GAO	General Accounting Office
GSA	General Services Administration

CHAPTER 1

INTRODUCTION

The Internal Revenue Service (IRS) and States routinely exchange large amounts of tax information. ^{1/} This exchange should increase tax revenues, reduce duplicate audits, and increase taxpayer compliance. Under section 6103(d) of the Internal Revenue Code, Federal tax returns and return information are open to inspection, solely for the purpose of tax administration, by any official, body, or commission lawfully charged with the administration of State tax laws. State laws, regulations, or agreements reciprocate by permitting IRS to inspect State tax returns. States, in fact, are the largest recipients of Federal tax information from IRS and receive information on millions of taxpayers.

IRS and States began exchanging information in the 1920s. Since 1957, exchange activities have been governed by a series of formal agreements between IRS and the States. The current agreement resulted from the new disclosure and confidentiality requirements of the Tax Reform Act of 1976. This agreement is uniform for all States and establishes general parameters on the types of information IRS and States can exchange. All but one State have signed the agreement.

Confidentiality of Federal tax return information is a primary congressional and public concern. In line with this concern, the Congress has historically attempted to restrict the disclosure of tax information, even to the point of limiting its own inspection privileges.

With regard to States, the Congress has recently been concerned that Federal tax information supplied may not always be adequately safeguarded and that political considerations may cause it to be used for nontax purposes. Despite these potential hazards, the Congress believes it is important that States continue to have access to Federal tax information for tax administration purposes. In the Tax Reform Act of 1976, the Congress reconciled these two positions by strengthening the Internal Revenue Code on disclosure of tax information and increasing the penalties

^{1/}Tax information generally includes any data relating to a taxpayer's identity, income, financial status, tax liability, and other information furnished with a tax return.

for unauthorized disclosure. It also increased IRS's responsibility for protecting tax return confidentiality.

Whenever tax information is exchanged on a large scale--as it is between IRS and the States--the probability of loss of confidentiality is increased. Thus, limiting the quantity of exchanged information to what is genuinely needed is a fundamental step that should be taken to reduce unnecessary disclosures and the risk of unauthorized disclosures. Such a step would not be contrary to an effective exchange program. Both IRS and the States could strive much harder to protect the confidentiality of tax information, while at the same time insuring that each is fully meeting the other's genuine needs for tax information. Neither party has to suffer a loss of benefits because of the necessity to preserve privacy.

Most tax information flows from IRS to the States. IRS district offices, service centers, and the national computer center are involved in exchanging tax information with the States. IRS provides the tax information in the form of audit report abstracts, computer tapes, copies of tax returns and, to a lesser degree, other media, such as name and address labels.

Although the agreement between IRS and each State is uniform, implementation varies widely from State to State because of State tax laws and the relationships and negotiations between the State and local IRS offices. Accordingly, some States receive different types and/or greater volumes of Federal tax information than others.

A schedule of the types and amounts of Federal tax information received by each State is included as appendix III.

BENEFITS FROM EXCHANGE OF TAX INFORMATION

IRS and the States recognize that mutual benefits can be derived by exchanging tax information. States attain significant benefits, both tangible and intangible, by using Federal tax information. While IRS recognizes the value of State tax information, it has derived far fewer benefits than the States. Both could do more to increase their respective benefits.

Because IRS does not maintain information on State benefits, we sent questionnaires to all 50 States and the District of Columbia to obtain information on each State's involvement in tax exchange activities. ^{1/} As shown in the following table, these questionnaires disclosed that State tax agencies assessed more than \$182 million in additional income and other taxes in 1976 by using one or more types of Federal tax information. This figure is conservative because only 46 States were able to estimate the dollar benefits attributable to their use of Federal tax information.

<u>Types of Federal tax information</u>	<u>Number of States reporting dollar benefits in 1976</u>	<u>Estimated additional State taxes assessed</u>
IRS audit reports	46	\$137,703,890
Computer tapes	28	38,176,901
Tax returns identified by IRS as having good audit potential	3	1,662,049
Other tax information (primarily estate and gift tax data)	5	<u>4,534,594</u>
Total		<u>\$182,077,434</u>

Aside from being used to assess additional State taxes, Federal tax information is also used to a lesser degree to provide taxpayers with additional State refunds. Twenty-nine States reported \$5,494,000 in additional State refunds as a result of using Federal tax information.

As would be expected, States rely heavily on Federal tax information in their audit and enforcement efforts. The above \$182 million in additional State tax assessments represents nearly half of the \$368 million total additional income tax assessments reported to us by 42 States with a personal income tax as being derived through their audit and enforcement efforts. For those States with well established

^{1/} For purposes of this report the District of Columbia will be considered a State.

audit systems, the use of Federal tax information significantly supplements the State's own enforcement operations. For many States with limited audit operations, the use of Federal tax information may constitute the predominant part of their tax effort. The extent of State reliance reported to us by 45 States is shown below.

Percentage of audit and enforcement assessments attributable to IRS information

	<u>Number of States</u>
More than 80 percent	5
61 to 80 percent	5
41 to 60 percent	8
20 to 40 percent	13
Less than 20 percent	<u>14</u>
Total	<u><u>45</u></u>

State tax assessments based on IRS-supplied information result in benefits not only in the period acted upon but in future years as well. Accumulative permanent gains, particularly from computer tape matching programs, are reflected in later years in increased State tax collections. Once on the tax rolls, taxpayers discovered through tape matching programs customarily become permanent taxpayers and file their returns annually. Thus, year after year, Federal tax return information contributes to expanding the States' tax bases.

Aside from obvious dollar benefits, some States have indicated that information received from IRS provides an immeasurable but important deterrent effect. They believe that the mere knowledge among taxpayers that IRS is supplying States with information acts to deter nonfiling and underreporting of taxes. To promote this deterrent effect, some States issue news releases on their receipt of Federal tax information from IRS.

IRS receives lesser dollar benefits than States from exchange of tax information and does not rely heavily on State tax information when doing its audits. In 1976 IRS reported \$6.8 million in additional taxes and penalties

assessed by auditing 16,457 returns based on State information. At IRS service centers, State tax information was one of the most profitable sources of audit revenue per return.

Although reported benefits of tax information exchange activities are considerable, more could be done to increase the volume of benefits to both IRS and States. Improved IRS management of exchange activities, including more specific definition of IRS and State information needs, would help to maximize tax revenues for both parties.

SCOPE OF REVIEW

The Joint Committee on Taxation requested that we review the Federal-State tax information exchange program, including methods of exchange, extent of the program, access to and controls over exchanged information, and the use of such information.

During 1977, when we did our fieldwork, IRS, in response to the Tax Reform Act of 1976, was preparing requirements on physical security and safeguarding of Federal tax information by States as well as related IRS inspection guidelines. Accordingly, it was too soon to assess the adequacy of access to and controls over exchanged information.

Our review focused on tax exchange activities carried out during calendar year 1976. We

--reviewed pertinent IRS and State records,

--interviewed IRS and State representatives involved in exchange activities, and

--mailed questionnaires to the tax departments of all 50 States and the District of Columbia.

We did our work at IRS national office, Washington, D.C.; at 5 of the 7 IRS regions; 17 of 58 district offices; and 8 of 10 service centers. We also worked at the tax departments of 13 States representing 40 percent of the Nation's personal-income taxpayers and accounting for more than 70 percent of all States' personal-income tax revenues in 1976.

A list of specific locations visited is included as appendix II.

CHAPTER 2

EXCHANGE ACTIVITIES HAMPERED BY

INADEQUATE PROGRAM MANAGEMENT

IRS has no formal program for exchanging information with States and, in fact, devotes relatively little effort to exchange activities. Because of the low priority which IRS has historically given to tax information exchange activities, it and the States have not defined their mutual information needs specifically enough. As a result, States receive much information they do not need or use and IRS is not making available some information which the States could use. Conversely, IRS has not taken advantage of much State tax information.

STATES GET UNNEEDED FEDERAL TAX INFORMATION

The Tax Reform Act of 1976 recognizes the importance of States receiving Federal tax information but stipulates that States adequately safeguard it against misuse and unauthorized disclosure. The first safeguard against these abuses is the limiting of exchanged information to the minimum needed--the time-honored "need to know" concept.

In January 1976, the IRS Commissioner stated that, in determining the extent to which States should have access to Federal tax information, a key factor to be considered is whether the tax information is necessary to the requesting agency's function. Although this principle is sound, IRS has not implemented it.

IRS has no policies or plans which restrict States to only that Federal tax information they can and will actually use nor has it provided the States with only the specific information they do need. Consequently, States receive a large volume of Federal tax information which they do not use or need.

As would be expected in the absence of a policy, IRS is unaware of how much Federal tax information the States are actually using. The Tax Reform Act of 1976 authorizes IRS to (1) provide States with Federal tax information to be used solely for tax administration purposes and (2) review and report to the Congress regularly on the adequacy

of States' physical security over Federal tax information. IRS is not explicitly required to determine if States do not use any or all of the Federal tax information they receive. However, it is obvious that nonuse is not "use solely for tax administration purposes." Although nonuse does not necessarily constitute misuse, it is an unnecessary disclosure of tax information. Any unnecessary disclosure is unjustified when it can be reasonably avoided.

From our review of IRS's draft guidelines for State security and discussions with appropriate IRS officials, it is apparent that IRS does not plan to review States' use of Federal tax information from the standpoint of how much is (and is not) being used. IRS should.

Many IRS audit reports received
but not used by States

IRS provides States with abstracts of IRS audit reports on individual and corporate taxpayers, which are used to adjust taxpayers' State tax liabilities. These include the more complex field and office audits from district offices as well as less complex correspondence audits from service centers. Much of this information is not used by the States.

In 1976, 47 States received almost 800,000 IRS audit reports on individual taxpayers and about 47,000 audit reports on corporate taxpayers. Eighteen of these States provided IRS with cutoff criteria (such as an increased Federal tax assessment of at least \$200) to use in screening the reports on individual taxpayers.

It is difficult to determine precisely how many of IRS audit reports overall are not being used by States because in most cases neither party maintains this type of information. However, in some States, as many as two-thirds of some types of audit reports received are not being used because the reports do not meet States' minimum dollar criteria and/or the Federal audit adjustments noted by IRS have no bearing on State tax issues.

For example:

- Some of the audit report adjustments received by Indiana pertain to itemized deductions. Itemized deductions have no bearing on Indiana's income tax. Accordingly, Indiana screened and destroyed 2,562 Federal audit abstracts in 1975, 25 percent of all received. In 1976, the State destroyed 2,345, or 22 percent of those received.
- In 1976, Ohio destroyed 8,065 audit reports because they could not be used to adjust the taxpayers' State liability. Many contained adjustments below the State's criterion for taking action, some were not relevant to Ohio tax liability, and some pertained to years before Ohio's income tax was adopted. Those destroyed were from the accumulated receipts of 1974, 1975, and 1976, and represented an estimated 50 percent of the individual audit reports received.
- In 1976, Minnesota received 37,000 audit reports of which two-thirds were not used because they did not meet their minimum dollar criteria and therefore were not cost effective to process.
- Kentucky did not use about 23 percent of the IRS audit reports received because some did not meet State criteria. Kentucky officials estimated, however, that half of the unused reports involved taxpayers for which the State had no record. Since the form used by IRS to summarize the audit does not contain the taxpayer's address, the State was unable to contact the person.
- Idaho received, but had no use for, audit reports on self-employment tax. A State official estimated that 2,900 such audit reports were unused during a 20-month period, but the State had not informed IRS of this problem.
- Utah received all the audit reports prepared by the Ogden service center. A State official said only about 50 percent of these were needed because

some were for adjustments to self-employment tax which Utah does not need, while other audit amounts were too small. A service center representative told us he provides all such information regardless of amount or State need to 14 States because the clerk who separates the State copy is not trained to separate audits using different State criteria. He is trying to get the 14 States to agree to a uniform cutoff.

--In New York, IRS district offices furnish all audit reports to State employees located on the IRS premises. The State employees screen out those which do not meet State criteria and copy the rest. To avoid the unnecessary disclosure of those reports being screened by State personnel, IRS could do the screening. The Andover IRS service center which provides audit reports to New York presently does extensive screening using State criteria and other IRS offices screen for other States.

--New York received estate tax audit reports, about 30 a year, from the IRS Albany district office. The reports were accompanied by the respective tax returns. The State kept these audit reports and returns in a locked filing cabinet and did not use them at all. State representatives said the information was not needed because the State would eventually receive the IRS closing letter on each of these estate tax cases from the IRS district offices in the State.

These examples of excessive disclosure could be eliminated if States defined their needs more specifically, as was done in Massachusetts and Wisconsin. In Massachusetts, the Andover service center used to screen all audit reports and furnish Massachusetts with only those having an adjustment in tax liability of \$200 or more. However, Massachusetts found that even with this screening procedure, about 18 percent of the audit reports received from IRS resulted in no change to State tax liability, mostly because the IRS audit adjustments had no bearing on State adjustments. Massachusetts reduced the nonusage rate by simply furnishing Andover with a list of about a dozen criteria to use in selecting audit reports. Massachusetts did not have to discard a single audit report from the reports screened by Andover service center using the new criteria.

In Wisconsin, many audit reports received from the Kansas City service center were not being used. Over a 5-month period in 1976, for example, Wisconsin did not use more than 60 percent of the 3,290 audit reports received, mainly because they had no relevance to State issues. A Wisconsin official stated that this problem was discussed with IRS officials and, as a result, IRS stopped sending the unusable audit reports.

Despite the fact that States do not use many IRS audit reports, they derive significant benefits from the reports they do use. As reported to us, audit reports on individuals resulted in nearly \$89 million in additional State tax assessments, representing the largest single source of benefits resulting from tax exchange activities. In addition, States reported almost \$2 million in State tax refunds based on IRS audit reports. IRS audit reports on corporations enabled the States to assess more than \$48 million in additional State taxes and refund an additional \$3.35 million.

States do not use much of the tax information on the Individual Master File tape

Annually, IRS makes available to each State, on a reimbursable basis, a computer tape--the Individual Master File (IMF) tape--containing information on each taxpayer in that State who filed a Federal tax return for the previous year. The tape is derived from IRS's master file of individual taxpayer information.

Each tape contains 19 uniform data elements on each taxpayer. Thirteen of these elements--name, address, taxpayer and spouse's social security numbers, marital status, exemptions, wages and salaries, adjusted gross income, interest income, taxable dividends, acceptable total tax, code indicating if IRS has selected the taxpayer's return for audit, and the amount of audit adjustment--can be considered particularly confidential.

In 1976, 41 States received an IMF tape containing information on their respective taxpayers. Overall, this amounted to 71 million taxpayers, or 86 percent of all individuals filing Federal returns. The tape serves many purposes. Thirty-eight of the 41 participating States used the IMF tapes to identify nonfilers of State tax returns, 26 used it to compare Federal and State tax data

to identify discrepancies, 8 used it to update mailing lists for State tax administration purposes, and 3 used it to identify Federal nonfilers. Twenty-eight States reported additional State tax assessments of \$37,873,148 in 1976 resulting from their use of the IMF tape.

Nevertheless, many of the 41 States did not use much of the confidential information on the tapes. Two States virtually did not use their tapes. One had received the tape for several years but had not used it. This State offered to return the tape in 1977 but IRS would not void the bill for preparing it. The other State was initially denied the IMF tape because it did not have a personal income tax. However, IRS later sent the tape which the State used for only one taxpayer. In total, the tapes for these two States contained information on more than five million taxpayers.

Sixteen States did not use any of the IMF data on many of their taxpayers because the taxpayers' adjusted gross incomes or taxable incomes were less than a pre-determined State cutoff level. For example, one State established a cutoff level for adjusted gross income, which excluded about 80 percent of the State's taxpayers. Accordingly, the State did not need or use any of the IMF data for these taxpayers.

Even where States used the IMF tape for all or some of their taxpayers, they did not use all 13 of the tape's particularly confidential data elements. The most frequently used elements included name, social security number, address, and adjusted gross income. However, one-third of the States used fewer than half of the confidential data elements. Only one State used all of the tape's confidential information.

When the confidential data elements are not used, there are numerous unnecessary disclosures. For example, because nine States did not use information on adjusted gross income, this information on about 20 million taxpayers was needlessly disclosed.

The disclosure of unneeded tax information could be eliminated if IRS provided each State with a reduced version of the IMF tape. In this version, each tape would contain only that information used by the individual State. The Privacy Protection Study Commission, in June 1976,

suggested something to this effect to IRS. ^{1/} In his response to the Commission, the IRS Commissioner indicated that technically and financially, eliminating information from the IMF tape to suit individual State needs appeared feasible. IRS estimated that modifying the IMF tape to suit each State's needs would cost about \$182,000 annually, an additional annual cost of \$72,000. Since IRS charges States for the cost of the tapes, the additional cost would be passed on to them.

As of October 1977, IRS had not implemented the Privacy Commission's suggestion. Rather, IRS was continuing its policy of providing a uniform tape to all States regardless of individual State needs. This policy was based on the belief that any deviation from a standard tape might open the door to excessive demands for different types and amounts of information. The requirements for confidentiality must be balanced against the perceived administrative concerns of IRS. In this case, confidentiality concerns should be paramount.

During our review, we told IRS officials on several occasions that it should modify its policy and provide each State with a tape containing only the information needed by that State. On November 25, 1977, after we had completed our fieldwork, IRS notified State tax agencies that it planned, to the extent practicable, to "tailor" the 1978 tapes to each State's particular needs and requested related information for planning purposes.

Florida receives excessive number of tax returns

States routinely inspect and/or receive copies of Federal tax returns. In 1976, 42 States copied or received copies of about 523,000 Federal tax returns from IRS, less than 10,000 of these being specifically requested by name. Florida accounted for 41 percent of the 523,000.

Florida's case presents an obvious example of excessive disclosure of Federal tax returns. It taxes intangible personal property, such as stocks and bonds. The State compares Federal and State tax return information to see which cases are worth auditing. In 1976 Florida employees inspected about 1.9 million Federal returns at the Atlanta

^{1/}The Privacy Protection Study Commission issued a report to the President and the Congress in June 1976 entitled "Federal Tax Return Confidentiality."

service center, microfilmed 216,066 of these returns, and sent the microfilm to Florida. However, Florida only used 55,632 returns (26 percent of the microfilmed returns and only 3 percent of those initially inspected). A State tax official said there probably are better ways to obtain Federal tax information but the current method works well for Florida.

In addition to inspecting and copying excessive numbers of Federal returns, Florida receives unnecessary tax information on each Federal tax return it microfilms. For example, the State microfilms the entire first page of IRS Form 1040 but uses only the taxpayer's name, address, social security number, and dividend income. Florida also copies all of Schedule B of Form 1040 (interest and dividend income) but it needs only the dividend income section.

IRS has been aware of the excessive disclosure situation in Florida at least since October 1974 but has not taken corrective action. IRS officials said that they have continued to allow Florida to microfilm tax information without masking out unneeded data because a masking procedure would be difficult and costly. However, appropriate State officials told us that it would not. Connecticut, for example, carried out a masking procedure with no apparent difficulty.

After we discussed this problem with the IRS Jacksonville district director, a regional analyst began working on it in June 1977. The analyst and the regional disclosure officer said IRS should establish some other system to insure that Florida gets only the tax information it needs.

There are several ways to minimize this excessive disclosure. A possible alternative would be for Florida to use the IMF tape to identify audit leads and then reproduce only those Federal returns needed for State audit purposes. This alternative, if used in 1976, would have resulted in Florida copying about 74 percent fewer Federal returns. Another alternative would be for IRS to prepare a special tape designed to include, to the extent possible, only the information Florida needs. This alternative would eliminate the screening and photocopying of returns by State personnel. A less desirable alternative would be to implement a masking procedure. Masking would not reduce the number of returns Florida inspects, but it would result in less information being unnecessarily disclosed to Florida on each return it microfilms.

New York does not use many
Federal tax returns with good
audit potential

IRS makes available to States information on taxpayers whose returns it has identified as having good audit potential. Audit potential is determined through a computerized scoring system known as discriminant function (DIF). The higher the DIF score assigned to an individual's return, the greater the potential for tax change. States use this information as a basis for auditing State returns, with results passed on to IRS for adjusting the taxpayers' Federal tax liability. This procedure allows increased Federal and State audit coverage while minimizing audit duplication.

In 1976 three States (New York, Kentucky, and the District of Columbia) received information on 15,870 individuals whose returns were identified by IRS as having good audit potential. New York received 97 percent of this total. New York provided IRS with criteria for selecting desirable returns and requested 15,440 for tax year 1975. The State received copies of the Federal returns accompanied by copies of the IRS audit classification sheets indicating the items worth auditing. The State did not use about 20 percent of the returns because

- staffpower cutbacks and shifts in audit emphasis precluded New York from auditing everything requested from IRS and
- some returns had little audit value to the State because its criteria did not adequately distinguish between Federal and State tax laws.

This excessive disclosure could have been at least partially reduced if New York and IRS agreed on more definitive criteria for the types of tax returns desired by the State.

STATES ARE NOT GETTING
SOME NEEDED INFORMATION

For a variety of reasons, States are not receiving much information of potential interest from IRS. In some cases, States have not adequately communicated their needs to IRS or have not vigorously pursued their requests. In other cases, IRS has not fully informed States of what is available

or has been lax in granting requests. This lack of interest by IRS appears to be due to the overall low priority IRS gives to the exchange of tax information.

We did not make a detailed review of State needs for specific Federal tax information. We did, however, identify some situations where States were not getting information apparently needed.

--In 1974, the Atlanta district office gave Georgia the names of about 2,000 taxpayers whose returns were identified as having good audit potential. Georgia officials said the State audited each of these cases and considered the program a success. In July 1974, IRS told the State that it planned to send similar information on a continuing basis. As of May 1977, IRS had not sent the information and State officials planned to send a letter to IRS formally requesting it.

--In 1974, Florida asked IRS for the names of corporate taxpayers with good audit potential which IRS did not plan to audit. The State would use this data as the basis for auditing corporations. IRS has not sent these audit leads, and a State official said Florida did not follow up on this request.

--State officials in Florida, Massachusetts, Indiana, Kentucky, and Ohio said they would like to get IRS audit reports for corporations doing business but not headquartered in their States. These audits are done by the IRS district offices in the States where the corporations are headquartered. The interested States could use the audit reports to determine what portion of the total IRS audit adjustment is applicable to them.

--Kentucky, Rhode Island, and Connecticut have requested but have not received service center audits.

--Rhode Island would like to receive a tape of gift tax information to identify nonfilers of State gift tax. New York receives such a tape and, since 1972, has recovered more than

\$1 million using it. The tape could also be used to identify nonfilers for IRS. Until our review, Rhode Island was unaware that such a tape existed but now intends to ask IRS for it.

These examples illustrate the need for IRS and States to communicate their needs and cooperate to fulfill these needs.

State needs could be more effectively met with special computer tapes

Much information that States need could be provided on computer tapes--either special tapes or tailored versions of the IMF tape. This procedure would not only insure that States receive the information they need but could, in some cases, greatly reduce unnecessary disclosures and the flow of excessive information to some States. Further, it would enhance efficiency by reducing the administrative costs of copying and manually recording the disclosed information.

IRS policy is not to make a change in the IMF tape just to accommodate one or two States, without giving the same treatment to all participating States. Nor has it been IRS practice to honor requests for special tapes for individual States because of its concern about excessive demands on resources and computer time. Accordingly, individual States have been denied special tapes and have had to use more costly and less convenient methods. In other cases, States end up with nothing. These problems are indicated by the following situations.

Connecticut taxes capital gains and dividends. Under current procedures, IRS, with the assistance of General Services Administration (GSA) employees, periodically provides the State with copies of relevant sections of Federal tax returns (about 392,000 pages of information in 1975). If IRS would furnish Connecticut with a tape of the desired information, Connecticut would receive the information it needs in an easily manageable form and would also save about \$61,000 in copying costs paid to GSA. This should result in substantial savings to the State because Connecticut pays only \$2,275 for the IMF tape. The most expensive IMF tape provided to States currently costs \$14,000. Also, IRS would not have to manually indicate in the taxpayer files that disclosures have been made, since this could be done by computer.

In Connecticut's case, most of the IMF tape information could be deleted since the State does not use it. The current IMF tape contains information on dividends but not on capital gains. However, capital gains information is available on tape at IRS service centers. Using this, IRS could generate a special tape of capital gains information as Connecticut has requested. An IRS national office representative refused this request because he feared that it would set a precedent for additional State requests. A service center representative told us, however, that such a tape could be easily prepared.

In 1974, Louisiana asked IRS about the availability of a tape covering filers of declarations of estimated income. IRS responded that although it did not maintain the exact data requested, it did have a data element which would assist Louisiana. However, IRS would not make a change in the IMF tape just to accommodate Louisiana.

IRS representatives said it is possible to provide additional information to States if the information is already contained in the IRS master file. Since the tapes are provided on a cost-reimbursable basis, it seems practical to add information to the State's IMF tapes if the information is already in the IRS master file. We recognize, however, that preparing special tapes may cause IRS some inconvenience to its normal operations. Accordingly, States should thoroughly justify their need for any specially requested tapes.

IRS IS NOT TAKING ADVANTAGE OF SOME STATE TAX INFORMATION

Although IRS receives and uses some State tax information, it is not taking advantage of other useful information States could provide. IRS recognizes the potential value of State tax information and has recently been considering how to better use such data. In June 1977, the IRS Deputy Commissioner stated:

"The Service has not made a broad scale effort to maximize the use of State information in Federal tax administration. This is not to say that we are not now realizing significant benefits from the use of State data, because we are. For example, certain cooperative audit arrangements are extremely beneficial. However, the Service has not been as aggressive as State tax administrators in pursuing potential opportunities."

As a result of this renewed interest by the Deputy Commissioner and other IRS representatives, the Acting Director of the Legislative Analysis Division formed an informal study group in June 1977 to explore the possibilities of obtaining State data to enhance IRS's compliance program. However, no deadline has been set for the group to complete its work, and it is unclear who will act on its recommendations.

This effort was preceded by other studies. In 1972 and 1973 IRS surveyed what data States had and in what format it was available to determine if the data lent itself to IRS use for a national compliance program. IRS concluded that not enough State record systems used a social security number or the employer identification number, the two preferable ways to key State records to Federal records to make a national compliance program feasible.

While a national compliance program may not be feasible, much State tax information can be useful to district offices and service centers for local compliance programs. For example, States could provide IRS with results of State audits and names of Federal nonfilers and underreporters.

IRS could use more State audit reports

Many States independently identify and select State returns for audit using their own criteria or tax formulas, but IRS does not take full advantage of these audits. In 1976, 39 States audited more than 5.3 million State-selected personal income tax returns. Twenty-three of these States reported at least some audit results to IRS, but the other 16 did not report any results of their audits on 445,000 taxpayers to IRS. It is conceivable that at least some of these audits could have been useful to IRS.

Many State audits of individuals are limited to correspondence. It is not clear why all IRS service centers do not want the results since correspondence audits are the service centers' forte. A State's revenue from correspondence audits is small--usually less than \$100 per case--but the yield to IRS would be larger since the Federal tax is generally greater than that of the States. In fact, the six service centers which used these State audit results found them to be one of their most profitable sources of audit revenue per return. In 1976 these centers assessed an average of \$347 in additional taxes and penalties per return using State audit results.

Many States also identify and select State corporate tax returns for audit. In 1976, 44 States audited approximately 583,000 State-selected corporate returns. Fifteen of these States reported some audit results to IRS but the remaining 29 did not report any results on their audits of 280,000 corporate taxpayers to IRS.

State officials told us that IRS has not asked for results of State audits. IRS officials in one district office said they are not anxious to obtain State audits because most are handled through correspondence and are simple. Other IRS officials indicated that sometimes staffing limitations may prevent IRS from using State audit results.

While these reasons may be valid, they should not preclude IRS from attempting to look at available State information. Some IRS offices are profitably using State information on audit results, which indicates that others could. Furthermore, the lack of aggressiveness by some IRS offices in seeking out useful State information is inconsistent with the recent interest expressed by IRS officials on obtaining State information.

Potential for IRS to identify Federal nonfilers using State information

The States, in matching the IMF tapes with State tapes to identify State nonfilers, could easily identify potential Federal nonfilers. However, IRS has not taken advantage of this apparent opportunity.

Only three States--California, Maine, and Utah--identify and report potential Federal nonfilers to IRS. At least four others--Connecticut, Idaho, Massachusetts, and Montana--are planning to do this, but at their own rather than IRS initiative. Massachusetts, for example, plans to send the State's version of an IMF tape to the Andover service center. The State tape for tax year 1975 contains filers' names, addresses, social security numbers, and all the information on the first page of the State return. Ironically, the State tape will cost IRS nothing even though the State pays IRS about \$4,500 for IRS IMF tape. The Massachusetts Tax Commissioner initiated this planned exchange. IRS officials at the Boston district office and at Andover service center were unaware of this planned exchange but district officials felt that it might be worthwhile.

Other States have useful information but neither they nor IRS have discussed the possibility of exchanging it. For example, one of the results of Rhode Island's use of the IMF tape is a computer printout of State taxpayers not listed on the IMF tape as having filed a Federal tax return. The State has no objection to providing IRS with this printout but IRS has never asked for it. Providence district office representatives thought that this information would not benefit IRS because they suspect most of these Federal nonfilers would be residents of other States and would be on another State's IMF tape. However, they indicated that they could not be certain unless they actually obtained the information from the State.

States with gift taxes can also identify Federal nonfilers. New York, for example, receives special gift tax tapes from two IRS service centers. New York then identifies both State and Federal nonfilers by matching Federal and State tapes. Starting in 1977 the State shared this information with IRS, but IRS has not yet used it.

Tests conducted by IRS with California in 1961 and Wisconsin in 1966 have shown that using State information to identify nonfilers can be productive. In California the project identified 1,500 Federal nonfilers from whom \$300,000 in additional taxes was collected. This represented a revenue yield of about \$500 per IRS staff-hour. In Wisconsin the project identified 900 nonfilers from whom IRS collected an additional \$259,000, a revenue-to-cost ratio of greater than 10 to 1.

Since States could easily identify suspected nonfilers, and since experience, although dated, has shown it to be profitable, IRS should seriously explore the feasibility of a Federal nonfiler project based on State information.

IRS receives other types of information which could identify nonfilers or underreporters. In 1976, 47 States reported to us that IRS requested copies of or access to at least 6,800 tax returns. This figure is conservative because four of these States were not able to estimate the number of tax returns IRS requested from them.

Thirty-five States routinely provided IRS with some of the following types of tax information in 1976:

<u>Tax information routinely provided to IRS</u>	<u>Number of State providers</u>
Estate or inheritance	26
Motor fuel	18
Highway user	13
Gift	10
Sales	5
Other	12

IRS mainly used estate and inheritance tax information to verify the taxpayers' credits to their Federal estate tax. Gift tax information includes audit reports, adjustments, and Federal nonfilers. State sales tax information includes results of sales tax audits, lists of sales tax registrations for selected occupations and businesses, and information on sales tax refunds. Other types of State tax information furnished to IRS include gambling and lottery information, State tax refunds, corporate franchise tax, property transfers, and court-awarded interest.

Many of the 13 States we visited had better audit coverage of motor fuel and highway user taxes than IRS; some had as much as 100-percent audit coverage. IRS district offices have taken advantage of this information, but none of the district offices we visited maintained a record of the extent.

OTHER PROBLEMS RELATED TO EXCHANGE OF TAX INFORMATION

Taxpayers not notified of possible changes in State tax liability

IRS does not notify taxpayers that IRS audit adjustments may also affect their State tax liability. The problem is compounded by the fact that many States do not receive IRS audit reports which result in refunds. Many taxpayers may not realize that a change in Federal tax liability may affect their State tax liability and, accordingly, may fail to file an amended State return.

As a matter of equity and to increase goodwill, IRS should notify each taxpayer that any change in his or her Federal tax liability as a result of IRS audit might affect his or her State tax liability. Informing taxpayers of the possible need to file an amended State return might save them money for penalties and interest under State tax laws. IRS could inform the taxpayer by including such a notice in its normal notification to the taxpayer of the results of his or her IRS audit.

Outlook for "piggybacking" is dim

A form of Federal-State cooperation which appears highly desirable, but which is not being used, is "piggybacking"--Federal collection and administration of State individual income tax as authorized by the Federal-State Tax Collection Act of 1972. All but nine States now have a broad base individual income tax and are candidates for piggybacking.

The Tax Reform Act of 1976 requires that only one State has to elect piggybacking before IRS can set up the implementing mechanisms. However, since piggybacking was authorized in 1972, no State has elected to participate. In September 1977 IRS published proposed piggybacking regulations.

Proponents argue that it would improve the overall efficiency of tax administration by (1) eliminating administrative duplication, (2) reducing State paperwork, (3) simplifying tax compliance due to the one-return system for both Federal and State income taxes, (4) providing a standard definition of residence so that it would be more difficult for individuals to evade State taxes, and (5) speeding the flow of income tax revenue into State treasuries because the Federal withholding system expedites the deposit of withheld taxes.

States are reluctant to adopt piggybacking because they believe it invades their prerogatives to legislate and impose taxes. One of the most delicate issues to consider regarding Federal collection and administration of State taxes is how such a system might affect the legislative prerogatives of the State. State legislators realize that to adopt piggybacking, they must be willing to accept Federal philosophy and policy with respect to the definition of tax base and taxable income and accept changes in the Federal system whenever they occur.

Other objections cited by State tax officials in the 13 States we reviewed were:

- The Federal Government could not collect and deposit cash fast enough, thereby hurting a State's cash flow.
- Each time the Congress decreases the tax rate, the State would have to increase its tax rate just to keep even; but the State could not react fast enough and would withhold at the lower rate in the meantime, thereby hurting its cash flow.
- Voters believe that letting the Federal Government take over would result in higher taxes in the long run.
- States doubt that IRS would increase its staff to handle the additional workload in the enforcement area.

In short, States are unwilling to give up control of their taxing authority and have their tax policies determined by the Federal Government.

Federal and State tax information is improperly commingled

Although we did not review the adequacy of States' physical safeguards over Federal tax information, we noted a potential problem in some of the States we visited. Eight of the 13 States we visited commingle Federal tax information with the taxpayers' State records. These States are California, Florida, Idaho, Indiana, New York, Ohio, Rhode Island, and Utah.

Existing IRS security guidelines specify that Federal tax information must be kept separate, to the fullest extent feasible, from State tax information and not maintained as a part of the administrative file of the State tax return. IRS's aim is to minimize the possibility of any inadvertent disclosure to unauthorized persons. Commingling Federal and State tax information increases the risk of inadvertent and unauthorized disclosure.

INEFFECTIVE PROGRAM MANAGEMENT
CAUSES THE PROBLEM

Ineffective IRS program management is the basic reason why Federal and State tax information needs have not been sufficiently defined. IRS exchange activities are fragmented, unsystematic, and uncoordinated. Also, the absence of an overall policy on restricting States to only the information they use has contributed to excessive disclosures.

IRS/State information exchange activities are conducted informally even though they involve formal written agreements and are consistent with the general disclosure policies applying to the change of all tax information. There are, however, no formal and uniform policies, procedures, and guidelines for limiting States to only that information they need and can use. No one person or unit has overall responsibility. IRS devotes few resources to exchange activities and has given the entire effort a low priority.

As early as 1970, an IRS Audit Division ad hoc study group recognized that exchange activities were "seriously lacking in unified direction and control." In a report to the Director of the Audit Division, the study group found

- a lack of unified direction at the national level or any level;
- little consistency in the type of information acquired from States and in the use made of it; and
- no real effort, either locally or nationally, to determine what State information was available or its value to IRS.

Several of the study group's recommendations were not implemented. They are:

- Establish a feedback system to each district so that each will be aware of the benefits obtained by other districts.
- Establish budgetary and priority considerations for the entire program.
- Furnish guidelines on availability of State information and how it should be used.

--Institute a management reporting system to assess the value and direction of the program on a continuing basis.

We were unable to determine why these recommendations were not implemented but believe they remain valid and relevant to an effective exchange program for IRS.

Program responsibility fragmented

No one official or unit in IRS has overall responsibility for directing, controlling, and evaluating exchange activities. The exchange of tax information is administered individually by each IRS district office, each service center, and the national office, with little or no coordination among the various components. Several IRS divisions responsible to three separate assistant commissioners operate various facets of the program.

<u>Assistant commissioner</u>	<u>Division</u>	<u>Program facet</u>
Planning and Research	Legislative Analysis	Establishing agreements with States and providing general leadership
Data Services	Service and Design	Preparing and providing IMF tapes
Compliance	Audit	Exchanging audit reports with States
	Disclosure Operations	Maintaining liaison with individual States and implementing disclosure requirements

IRS officials at all levels said that exchange activities have a low priority. This is especially apparent at the field level--district offices and service centers--where virtually all exchange activities are implemented. At these offices, one of the responsibilities of disclosure officers is overseeing exchange activities. However, they generally view their roles with respect to information exchange as

being limited to (1) reviewing States' physical security for Federal tax information, (2) insuring that only authorized information is disclosed, and (3) recording disclosures in taxpayers' files.

Most disclosure officers we spoke to did not think they were responsible for managing exchange activities to insure that States get useful and needed information. In fact, most disclosure officers told us that the bulk of their time is spent on other activities, mainly dealing with requests from the general public. They estimated that they spend less than 10 percent of their time on exchange activities.

District offices have not actively promoted tax exchange activities. Most of the district directors and district disclosure officers we contacted said that they will provide tax information based on a State's initiative, but if a State is not aggressive enough to ask what type of information is available, the district office will not voluntarily tell.

Absence of formal policies and procedures

The IRS national office has done little to clarify matters for the service centers and regional and district offices. While the national office is issuing new guidelines relating to physical security and disclosure, it has neglected to establish policies, procedures, and criteria dealing with such critical matters as methods of exchanging information, forms in which it should be exchanged, monitoring State use of information, and restricting the information provided to that which States can actually use. In the absence of this guidance, procedures are developed locally between district offices and service centers and States with little or no national office or, for that matter, regional office awareness. The one exception is the IMF tape which can only be obtained from the national office.

Because exchange practices vary in the field, some States with similar needs get differing types and amounts of information depending on the particular custom of each IRS district office and service center. Rhode Island, for example, receives gift tax audit reports from the IRS Providence district office but does not get Andover service center's gift tax tape as New York does. Apparently, the

service center never took the time to determine whether other States needed the information. District officials were aware of such information but they did not know that the State was not getting it. In other instances, some States received IRS audit reports resulting in refunds but most did not. At least one State which received them threw them away.

Lack of coordination

There is virtually no coordination among district offices and service centers. Many district office and service center disclosure officers said that they have very little contact and coordination with each other regarding the exchange program. This is indicated by the following examples:

- The Cincinnati district office was providing Ohio with audit reports meeting the State's cutoff criteria while the Cleveland district office was not considering the State's criteria and instead was sending all audit reports. In November 1977, IRS told us it had corrected this situation.
- The Memphis service center would not honor requests for information from Indiana and Kentucky because it did not know these States had agreements with the appropriate IRS district offices or that Indiana was receiving copies of tax returns via the Indianapolis district office.
- The Boston district office was unaware that Massachusetts obtained information from the Andover service center and that the State's cutoff criteria for audit reports were different for the service center and the district office.

Coordination problems often occur because the district offices negotiate most agreements between IRS and States. Service centers rarely enter into the negotiation picture. Consequently, States such as Rhode Island were not getting correspondence audits which the service center had performed.

Disclosure officers we spoke to agreed that it would be advantageous for them to meet periodically to better coordinate exchange activities. Some steps are being taken in this

direction. In a recent quarterly report, the Andover service center recommended that training and discussion sessions be held for service center disclosure officers. At the time of our review, the North Atlantic Region disclosure officer was also planning such a session which would include district office disclosure officers.

Implementation agreements--a positive step for letter coordination

As a supplement to the uniform Federal-State agreement, IRS and Wisconsin formulated an implementation agreement in 1976, which governs the actual exchange of tax information. The implementation agreement denotes the specific IRS field offices to be involved in exchanging information and describes in detail the exact types of information to be exchanged, fashioned to the requirements of the State and IRS. For example, rather than IRS merely agreeing to provide audit reports to the State, the agreement defines the specific types of reports Wisconsin is not interested in, thus helping to preclude the unnecessary disclosure of Federal tax information. The agreement also contains provisions on copying costs, notifying State personnel of criminal penalties for unauthorized disclosure, and notification to either party to discontinue submitting tax information.

IRS and Wisconsin officials believe that the implementation agreement has many advantages. It not only provides written instructions and guidelines for the exchange of tax information between IRS and the State but also avoids potential problems and errors due to employee turnover because certain details are readily available and in writing.

Although it is not the final answer to all of the problems hampering exchange activities, the implementation agreement is a good example of positive action for better coordination. Its expansion to other States, particularly those which exchange large amounts of information with IRS, could help to resolve many of the difficulties IRS and States have been experiencing.

Program results are unknown

IRS has not made it a practice to assess the results and effectiveness of tax information exchange activities.

IRS occasionally surveys program results; the most recent survey was in 1975. However, IRS questioned the validity

of the information. Until October 1976, IRS district offices and service centers were not required to report regularly to their regional offices or the national office on the volume and type of information given to the States. This reporting system, however, omits such important information as the use made by States of Federal tax information, additional tax assessments accruing to States, and costs of administering the activities. IRS cannot evaluate the effectiveness of exchange activities without this important fundamental data.

CONCLUSIONS

Complete and precise identification of each other's tax information needs is the keystone of an effective exchange program between IRS and the States. More accurate identification of State information needs would minimize the amount of information IRS gives to States and help insure that States get only what they can use. Tailoring computer tapes and screening IRS audit reports carefully are only two steps that could be taken to reduce unnecessary disclosure of information. Tailoring computer tapes seems especially feasible since they are provided to States on a cost-reimbursable basis. We recognize that States do not always use what they intend to use and that sometimes reducing disclosures may be impractical. But both IRS and the States can do more to protect the confidentiality of Federal tax information.

Identification of State needs is also the first step to insure that States receive tax information which they can use effectively. And by taking advantage of opportunities to receive and use State tax information, IRS would strongly benefit from exchange activities.

It is improbable that IRS can take the necessary actions for an effective exchange program given the current state of its program management--an obvious lack of structure, direction, and coordination. The full benefits of exchanging tax information with States will not be attained unless IRS pinpoints management responsibility for this activity and gives it a higher priority. This can be done without an extensive expenditure of resources. But until it is done, IRS and the States miss an opportunity to increase tax collections and improve taxpayer compliance.

RECOMMENDATIONS

We recommend that the Commissioner of Internal Revenue:

- Fix managerial responsibility at the national office level with authority to coordinate all aspects of the program.
- Fix responsibility for managing the program at the regional, district, and service center levels.
- Establish formal policies, procedures, and guidelines for implementing, monitoring, and evaluating the program. This should include a written policy of restricting States to receiving only that Federal tax information they genuinely need and use.
- Completely evaluate each State's need for and use of Federal tax information, as well as IRS's need for State tax information.
- Tailor magnetic tapes of tax information to the particular needs of each State.
- Develop an implementation plan with each State spelling out the exact types and amounts of information to be exchanged and the methods of exchange.
- Require States to provide precise cutoff criteria and screen out, where appropriate, IRS audit reports and DIF-scored returns which do not meet the criteria provided.
- Include as part of security reviews at States a determination that Federal tax information provided is actually used and that it is used for tax administration purposes only.
- Obtain feedback from States on additional tax assessments or other benefits resulting from IRS-supplied information.
- Notify taxpayers that any change in their Federal tax liability resulting from IRS audit could affect their State tax liability.

IRS COMMENTS AND OUR EVALUATION

In a March 9, 1978, letter, the Commissioner of Internal Revenue said that IRS agreed generally with the substance of our recommendations and has organized a task force to study them in detail and plan their implementation to the maximum practicable extent. Along with his response, the Commissioner attached a copy of the task force prospectus containing information about the study purpose and objectives. (See app. I.)

When discussing the prospectus in a later meeting, the Deputy Commissioner said that once the task force completes its study on June 1, 1978, the results would be sent to us and the Joint Committee on Taxation and action would be taken to correct deficiencies.

STATES' COMMENTS AND OUR EVALUATION

We sent a copy of a draft of this report to each of the 15 States discussed in it for their review and written comments. All 15 States responded. None disagreed with the overall conclusions and recommendations. Three States provided primarily technical comments, and we made changes to the report when appropriate. For other than technical comments, the responses ranged as follows:

- Eight States generally agreed with the report.
- Three States commented that the report was accurate but expressed concerns. Two of these thought the report overstated the findings, while the other was apprehensive that the report could be used to damage the exchange program.
- One State disagreed with our finding that it receives excessive numbers of Federal tax returns.

Eight States agreed with the report

The eight States which generally agreed with our findings, conclusions, or recommendations were Connecticut, Georgia, Idaho, Indiana, Kentucky, Louisiana, Massachusetts, and Ohio. Examples of their comments follow:

- Georgia's comments included, "* * * we concur with this report that certain unnecessary disclosures could be eliminated by defining the information which will actually be used by the State of Georgia for tax administration purposes."
- Louisiana's comments included, "The recommendations contained in the report seem to have merit and are consistent with our views."
- Ohio's comments included, "We have reviewed the report and in general agree with the recommendations."

Three States expressed concerns about the report

Utah's and Wisconsin's comments noted that although the reported findings appeared accurate, they may be over emphasized. Minnesota stated that the report was factual, but it was apprehensive that the report could damage the exchange program.

Utah

Utah's comments included:

"* * * shortcomings cited in the draft report are for the most part correct although the gravity of the offences seem to be somewhat over-emphasized. For example, while we have received information in this office that was not used, we in no way equate this non-use with mis-use."

We understand Utah's perspective and concern. But we did find large quantities of nonuse of Federal tax information in numerous States. Further, confidentiality of Federal tax information is a primary congressional and public concern. And, as discussed in the report, limiting the exchange of Federal tax information to that which is genuinely needed is a fundamental step toward protecting confidentiality.

We agree with Utah's comment that nonuse should not be equated with misuse. Although nonuse does not necessarily constitute misuse, it is an unnecessary disclosure of tax information. Any unnecessary disclosure is unjustified when it can be reasonably avoided.

Wisconsin

Wisconsin's comments included:

"While * * * the report is well written and states the facts precisely it does dramatize, perhaps unnecessarily so, shortcomings which are procedural and subject to easy correction."

Wisconsin was concerned that people might think the program "is sloppily administered."

Although we agree that some problems may be procedural and easy to correct, many are not. For example, our recommendation that IRS completely evaluate each State's need for Federal tax information as well as IRS's need for State information do not stem from a procedural problem and may be difficult to implement. Our objective in pointing out administrative problems to be corrected was to further improve an already worthwhile program.

Minnesota

Minnesota's comments included:

"If, as a result of your report, the foes of Federal/State Tax Cooperation and the secrecy people were motivated or overreacted, grave damage could be done to existing relations."

Any damage to the Federal-State tax exchange program as a result of our report would be unfortunate and contrary to our intent. We stated that the program has resulted in benefits to IRS and States. Furthermore, we believe the program is important and, with improvements, can produce even greater benefits while at the same time protecting the confidentiality of the exchanged information.

Florida disagreed that it received excessive numbers of Federal tax returns

Florida disagreed that excessive Federal returns were disclosed to the State and commented that the report does not fairly assess its use of Federal tax information.

But its comments included:

"As part of our continuing review of screening criteria, we have implemented adjustments for 1978 that will reduce the number of returns microfilmed by 40 to 50 percent, except every third year. This adjustment was implemented to overcome microfilming returns that are presently used infrequently."

The adjustments made by Florida in 1978 are a positive step toward reducing unnecessary disclosures.

Florida also pointed out several technical matters, not discussed in our report, which it believes should be addressed when assessing how it uses federal tax information. In our report, we presented several broad alternatives to Florida's current method of obtaining Federal tax information in an effort to minimize excessive disclosures. We did not address all of the technical implications of our suggested alternatives nor try to arrive at a single answer to the excessive disclosure problem. IRS and Florida should.

We believe that IRS and Florida are in the best position to assess Florida's Federal tax information needs, including analyses of all technical matters. IRS has begun to do this. In June 1977, as a result of discussions with us, IRS appointed an analyst to examine the total information exchange process in Florida.

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

MAR 9 1978

Mr. Victor L. Lowe, Director
United States General Accounting Office
Washington, DC 20548

Dear Mr. Lowe:

We appreciate the time and effort spent by your staff reviewing the exchange of Federal and State tax information. We agree generally with the substance of your recommendations; and we have organized a task force to study them in detail and to plan their implementation to the maximum practicable extent.

Attached for your information is a copy of the prospectus for this task force. We would be glad to consider any comments or suggestions you may have with respect to the prospectus.

With kind regards,

Sincerely,

Attachment
Copy of the Prospectus

PROSPECTUS

Proposal to create a task force to study the recommendations of the General Accounting Office in its draft report entitled: "IRS Needs to Better Manage the Exchange of Federal and State Tax Information."

BACKGROUND AND PURPOSE

As stated in our comments on the GAO draft report now in clearance, we are in agreement that GAO's recommendations raise serious questions as to the future course of the IRS-State exchange relationship and of the Service's methods of handling same. The GAO report creates the opportunity to assess an area which frequently has not been given sufficient management emphasis since it is out of the main stream of the Service's activities. This area has assumed more critical importance due to the enactment in the Tax Reform Act of 1976 of the new tax disclosure laws. These new provisions have placed broad new areas of responsibility on the Service as they mandate our attention not only to safeguard tax return information in the hands of those agencies authorized to receive same under the new law, but to ensure that such information is distributed only as truly needed. GAO has also recommended that the Service can enhance its own compliance and collection programs through more and better use of tax data garnered by the states--an opportunity which we ought to exploit to the fullest.

Consequently, we believe there is a critical need to form a task force to examine the problem areas identified in the GAO study as well as GAO's recommendations and to advise management how best to proceed.

OBJECTIVES

The study group will be given wide latitude in the conduct of this study so that they can be fully responsive to its purpose and objectives. The objectives set forth below should be realized to the extent possible. However, if additional items are identified during the course of the study, the group will address itself to such items and include them in its report. Present objectives are:

1. Review current delegations of authority and organizational configuration to recommend where in the National Office responsibility for the coordination of the IRS-State relationship ought to be fixed.
2. Review current IRS-State exchange operations and recommend where responsibility for this program at the regional, district and service center levels ought to be fixed.

3. Review all pertinent Service policies, manual issuances and other directives with a view toward determining what additional instructions to the field are necessary to a sound and practical administration of this area. This objective would include consideration of what additional policy statements are necessary to govern the amount, need and uses for Federal tax data by the states.
4. Are additional mediums for governing the exchange, such as the "Implementation Agreements" in use in some districts and recommended by GAO for more widespread use, advisable?
5. Review the current methods of exchange to determine if data can and should be more specifically tailored to the type and quantity actually usable by the state. Recommend the best methods of arriving at the appropriate formula for determining the best type and amounts of data to be exchanged. Examine the variety of current field procedures now in use and determine if such procedures can or should be made uniform.
6. Study the current methods prescribed for the conduct of state security reviews and advise as to how same can be improved upon. This study should include recommendations as to how best to ensure that such reviews include an assessment as to the states' need for and use of Federal tax data.
7. Determine the potential of state tax data not now being realized by the IRS. Analyze the cost of obtaining and processing such information as against the benefits to be realized.
8. Study and advise as to how and to what extent taxpayers should be advised of the impact of the IRS-State exchange on their own tax affairs.
9. Analyze what additional steps, if any, should be taken to obtain greater feedback from the states as to additional tax assessments or other benefits derived from IRS supplied information.

METHOD OF STUDY

Members of the study group should visit district, service center, and regional offices as the proceedings of the group point to informational needs. Initially two regional offices may be visited. If necessary other regional offices may be visited. Travel costs are the maximums now considered probable and are shown under "Cost of Study" below. Visits may also be made to state tax agencies. Consultations with N.A.T.A. and similar organizations might also provide useful input.

A thorough review of all existing and proposed policy statements, manual issuances, exchange agreements, implementation agreements, and regulations will be conducted. An analysis of selected state laws impacting on this area will also be undertaken.

Additionally data analysis will be utilized to explore the full impact of information exchange on Service resources and the best methods of exchange available.

The task force will report back to the Deputy Commissioner not later than June 1, 1978.

It is preferable to approach a study of this type by developing specific questions to be answered in relation to each objective. Listed below are some specific questions of this type. These are not all-inclusive; the study group will extend, revise or amend the questions as circumstances dictate. It will be essential, however, that adjustments to the questions set forth in this prospectus be shared with all members of the study group so that uniform surveys and discussions with field and National Office officials can be assured and meaningful evaluation guaranteed.

Objective 1 - Organizational Configuration - National Office Level

A. To what element of the National Office should coordination of these activities be centralized? Related questions involve the proposed organizational configuration including required staffing and delegations of authority.

Objective 2 - Responsibility in the Field

A. To whom will field responsibility for the program be assigned-- at the district and regional office level?

B. To whom will such officials report and from whom will they receive technical guidance? Managerial direction?

C. To what degree should the District Director, appropriate ARC or Regional Commissioner become involved in the program?

Objective 3 - Review of Pertinent Directives

A. What basic policy statements are needed to serve as the foundation for further guidance to responsible operating officials?

B. Are further delegations of authority necessary and appropriate? What degree of local discretion will be vested in the field and to which officials?

C. What implementing manual provisions are necessary beyond those presently in process or currently in issuance?

D. What basic coordination is required to ensure effective direction and control of this program? How will it be accomplished?

E. What is the legal basis for limiting state access to tax data to only those elements IRS believes they genuinely "need" or can "use?" How will the determination of "need" or "use" be made?

Objective 4 - The Exchange Agreement - The Implementation Agreement

A. Does the "Implementation Agreement" approach now contemplated in proposed Chapter 33(00) of the new Disclosure Handbook and endorsed by GAO provide a framework for resolving problems identified in the Report or should the existing Exchange Agreement alone suffice?

B. What form will such an agreement assume? What general guidance should be issued, if any, beyond proposed Chapter 33(00)?

C. What "negotiations" or other preliminary discourse with the states should precede execution of agreements?

D. What permanent machinery for continuing liaison and oversight by IRS should be provided for in such agreements?

Objective 5 - Methods of Exchange

A. What ADP modifications can be made or need to be made to help promote interchange of data?

B. What is the effect on NCC or service center procedures and resources?

C. Given the variety of state administrative setups, can uniformity of procedure be attained? Should it be? What should be left to local devices?

D. Are district procedures adequate? Should standard procedures be developed or should local initiative continue?

Objective 6 - State Security Reviews

A. What is the legal basis for imposing an additional requirement re: need and use? What are the limits to which such legal theory may be employed? What are the consequences in the event of a state's failure to comply? What sanctions may be imposed by IRS?

B. Are instructions as to the conduct of such reviews adequate?

C. Is there a need for minimum standards and criteria not already prescribed?

Objective 7 - The Potential Value of State Tax Data

A. What are the costs? The benefits?

B. How may continuing liaison at appropriate operating levels to facilitate the receipt of this information be effected?

C. What further requirements should be published to ensure maximum use of state tax data by appropriate IRS elements?

Objective 8 - Making the Public Aware

A. What are the best ways to educate the public concerning the IRS-State exchange?

B. Can the Form 1040 or 1040A instructions be utilized for this purpose?

C. What further publicity efforts are appropriate or necessary?

Objective 9 - Better Feedback from States as to the Benefits of IRS Data

A. What arrangements can be made to secure accurate and meaningful data as to the benefits the states have derived from IRS supplied data?

B. Can such data be classified and assembled by the states to provide data of value to the Service?

C. Can this be arranged for in the "Implementation Agreement?"

COMPOSITION OF THE TASK FORCE

The task force would be chaired by a representative of the division most directly involved with this area presently and who would be familiar with all applicable laws and present procedures. We propose the Assistant Director, Disclosure Operations Division, Arnold Gordon.

Other functions or positions to be represented on the task force and the reasons for their inclusion would be:

Function/Position

Compliance (Audit Division)**	This Division is the most directly affected at the district and service center levels. by the exchange of data with the states.
Planning & Research (Legislative Analysis)**	This function is currently charged with overall responsibility for IRS-State liaison including preparation and review of the Exchange Agreements.
Regional Disclosure Officer*	The force would benefit from the experiences of a field official who has day-to-day contact with these problems.
ACTS**	Most of the data exchange takes place at the service center. GAO recommendations impact heavily on service center operations.
Data Services **	The GAO recommendations focus on the Service's ability to tailor magnetic tape information to the needs of the individual states. These questions impact on Data Services' programs and require, for their resolution, ADP expertise.
State Tax Agency Official***	The results of the study impact heavily on state tax administration. The availability of state tax data is also a prime subject for analysis.
Chief Counsel	A full resolution of these problems may have legal implications. Counsel would be asked to have a staff attorney on call who would be familiar with this area.
Security Standards & Evaluation Division**	Much of this study has security implications.

*The Director, Disclosure Operations Division would make this nomination with the concurrence of the affected Regional Commissioner.

**To be nominated by the Assistant Commissioners affected.

***We intend to seek nominations from N.A.T.A. to fill this requirement. This person may be employed as a consultant or a temporary employee when actually engaged on the task force's work.

COST OF STUDY

This study will require approximately one-half of six people's time for a period of four months. Additionally, as noted above a representative from Administration and Chief Counsel would be on call. Estimated personnel costs are calculated at Step 5 of each grade specified. The State agency official's pay grade will be assumed to be at the equivalent of Step 5 of a GS-15 although this item has not been finalized.

2 GS-15	\$13,664	
4 GS-14	23,330	
1 GS-5	<u>1,880</u>	(one month's clerical work)
Total	\$38,874	

Estimated Travel Costs

Seven 4-day trips
Four meetings in Washington, D. C.

Per Diem	\$2,000
Transportation	<u>\$3,000</u>
Total	\$5,000

Prospectus Approved:


Deputy Commissioner

LOCATIONS WE VISITED

In addition to IRS national office, Washington, D.C., we visited the following locations.

<u>IRS regional offices</u>	<u>IRS district offices</u>	<u>IRS service centers</u>	<u>State tax departments</u>
Atlanta	Albany	Andover	California
Chicago	Atlanta	Atlanta	Connecticut
Cincinnati	Boise	Brookhaven	Florida
New York	Boston	Cincinnati	Georgia
San Francisco	Brooklyn	Fresno	Idaho
	Cincinnati	Kansas City	Indiana
	Cleveland	Memphis	Kentucky
	Hartford	Ogden	Massachusetts
	Indianapolis		New York
	Jacksonville		Ohio
	Los Angeles		Rhode Island
	Louisville		Utah
	Manhattan		Wisconsin
	Milwaukee		
	Providence		
	Salt Lake City		
	San Francisco		

STATE ESTIMATES OF FEDERAL TAX INFORMATION

RECEIVED DURING CALENDAR YEAR 1976

State	Number of taxpayer records received on IMF tape	Number of IRS audit reports received		Number of Federal tax returns identified by IRS for State audit	Number of copies of Federal tax returns received	Other Federal tax information received (note a)	Estimated additional State taxes assessed as a result of using Federal tax information
		Individuals	Corporations				
Alabama	(b)	9,666	898	-	457	Yes	\$ 833,000
Alaska	148,773	1,000	4	-	1	No	414,500
Arizona	828,780	18,656	265	-	10	Yes	1,565,701
Arkansas	693,774	3,000	360	-	368	Yes	1,172,800
California	8,477,454	216,000	8,000	-	900	Yes	45,839,772
Colorado	1,032,760	21,000	1,000	-	-	Yes	588,900
Connecticut	1,257,917	349	917	-	-	Yes	1,875,000
Delaware	230,263	2,500	150	-	25	No	787,000
District of Columbia	309,622	4,078	14	200	4,284	Yes	2,997,400
Florida	3,128,167	-	1,431	-	216,239	Yes	8,718,949
Georgia	1,759,553	9,115	397	-	250	Yes	5,264,660
Hawaii	345,444	4,000	480	-	12	Yes	420,466
Idaho	305,240	6,399	(c)	-	2,000	Yes	391,999
Illinois	4,436,497	d/6,628	(e)	-	f/847	Yes	d/3,814,247
Indiana	1,999,208	10,000	1,500	-	20	Yes	1,849,702
Iowa	1,102,841	3,725	240	-	10	No	1,002,000
Kansas	(b)	3,824	390	-	100	Yes	769,575
Kentucky	1,153,792	12,130	445	670	-	Yes	1,144,878
Louisiana	1,259,516	5,000	850	-	200	No	5,850,000
Maine	403,401	6,000	200	-	24	Yes	635,000
Maryland	1,620,935	7,200	-	-	7,250	No	1,943,228
Massachusetts	2,288,684	13,000	1,720	-	162	No	10,192,000
Michigan	3,319,749	28,611	639	-	379	Yes	6,094,102
Minnesota	(b)	37,123	1,241	-	249	Yes	3,635,847
Mississippi	709,238	900	250	-	1,175	Yes	2,000,000
Missouri	1,766,180	17,100	1,416	-	50	No	2,252,441
Montana	290,827	4,987	166	-	200	Yes	1,304,081
Nebraska	607,048	13,000	60	-	10	No	669,500
Nevada	(b)	-	-	-	-	No	-
New Hampshire	335,215	1,382	257	-	30	Yes	447,947
New Jersey	2,895,873	-	300	-	50	Yes	250,000
New Mexico	417,745	1,120	100	-	20	Yes	699,000
New York	6,700,239	192,000	11,000	15,000	207,000	Yes	38,032,458
North Carolina	(b)	19,670	1,015	-	1,541	Yes	4,258,665
North Dakota	244,242	2,700	40	-	100	Yes	386,000
Ohio	4,131,250	4,200	2,400	-	200	Yes	670,000
Oklahoma	976,103	70,000	1,000	-	72,000	Yes	1,350,000
Oregon	(b)	g/4,328	g/561	-	100	Yes	1,161,720
Pennsylvania	4,533,875	-	3,944	-	15	Yes	7,225,958
Rhode Island	373,448	4,032	810	-	-	Yes	1,511,446
South Carolina	(b)	769	186	-	-	Yes	924,274
South Dakota	(b)	-	5	-	34	Yes	-
Tennessee	1,513,156	-	700	-	400	Yes	2,400,000
Texas	4,565,988	-	-	-	-	No	-
Utah	435,927	6,000	225	-	6,184	Yes	350,000
Vermont	178,535	3,764	100	-	-	Yes	593,218
Virginia	1,899,333	5,750	500	-	25	Yes	4,650,000
Washington	(b)	-	-	-	10	Yes	-
West Virginia	609,826	600	-	-	12	No	290,000
Wisconsin	1,768,306	19,000	914	-	-	No	2,850,000
Wyoming	(b)	-	-	-	6	Yes	-
Total	71,054,724	799,806	47,090	15,870	522,949		\$184,077,434

a/Includes tax information on one or more of the following--estates, gifts, employers, exempt organizations, motor fuel, highway users, and others.

b/State did not receive IMF tape in 1976.

c/Unknown.

d/For fiscal year 1976.

e/Included in total for individuals.

f/For July 1, 1976, to June 9, 1977.

g/Represents number audited by State rather than the number received.

PRINCIPAL TREASURY OFFICIALS
RESPONSIBLE FOR ADMINISTERING
ACTIVITIES DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF THE TREASURY:		
W. Michael Blumenthal	Jan. 1977	Present
William E. Simon	Apr. 1974	Jan. 1977
George P. Shultz	June 1972	Apr. 1974
COMMISSIONER OF INTERNAL REVENUE:		
Jerome Kurtz	May 1977	Present
William E. Williams (acting)	Feb. 1977	May 1977
Donald C. Alexander	May 1973	Feb. 1977
ASSISTANT COMMISSIONER (COMPLIANCE):		
Singleton B. Wolfe	Mar. 1975	Present
Harold A. McGuffin (acting)	Feb. 1975	Mar. 1975
John F. Hanlon	Jan. 1972	Jan. 1975
ASSISTANT COMMISSIONER (ACCOUNTS, COLLECTION, AND TAXPAYER SERVICE) (note a):		
James I. Owens	May 1977	Present
James I. Owens (acting)	July 1976	May 1977
Robert H. Terry	Aug. 1973	July 1976
ASSISTANT COMMISSIONER (DATA SERVICES) (note a):		
Patrick J. Ruttle	Jan. 1977	Present
ASSISTANT COMMISSIONER (PLANNING AND RESEARCH):		
Anita F. Alpern	May 1975	Present
Anita F. Alpern (acting)	Jan. 1975	May 1975
Dean J. Barron	Aug. 1973	Dec. 1974

a/Effective January 2, 1977, responsibility for IRS system design, programing, and analysis as well as National Computer Center and Detroit data center operations was transferred from the Assistant Commissioner (Accounts, Collection, and Taxpayer Service) to the Assistant Commissioner (Data Services).