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PRESENTATION OF  
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ON THE  
[ UNDERGROUND ECONOMY -- WHAT CAN AND SHOULD BE DONE:  
THE FEDERAL ROLE ]

BEFORE THE  
SEVENTY-THIRD ANNUAL CONFERENCE ON TAXATION  
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I welcome the opportunity to participate in this conference session on the "underground economy" and to talk about what the Federal Government can and should do about the problem. My presentation is based on what we in the General Accounting Office have learned about income tax nonfiling and underreporting through audits of, primarily, the Internal Revenue Service (IRS).

Anyone concerned about maintaining the integrity of our voluntary tax assessment system has to be concerned over the findings of various researchers on the extent to which an underground economy exists in the United States. For example, if people had paid the \$26 billion taxes on the \$135 billion income which IRS estimated went unreported in 1976, 1 the Federal Government's fiscal year 1977 budget deficit would have been reduced from \$45 billion to \$19 billion, or by 58 percent.)

It is unfair to the vast majority of Americans who pay their proper amount of taxes that so many others do not. Therefore, it is imperative that the Government respond to this potential threat to our voluntary tax system by taking aggressive, but reasonable, action. Certain actions can and are being taken by IRS to improve its various programs to detect and deter noncompliance. Other actions, however, require congressional attention.)

FEDERAL PROGRAMS AND ACTIVITIES FOR DETECTING  
AND DETERRING NONFILERS AND UNDERREPORTERS

IRS has a broad range of compliance enforcement programs and activities to detect unreported income. These consist of

collections, document matching, withholding, audits or examinations, and criminal investigations.) The extent to which IRS uses each of these against nonfilers and underreporters varies and depends on whether their failure to file or report all their income is detectable through documentation or a "paper trail."

Our audit work in the tax administration area has indicated that while IRS had the programs and activities in place to deal adequately deal with the unreported income problem, it needed to improve the effectiveness of each. It also needed to combine the use of these programs and activities by (1) developing an overall compliance strategy which properly matches all forms of noncompliance with the best enforcement tool available and (2) reallocating its resources, accordingly.

INDIVIDUAL COMPLIANCE ENFORCEMENT  
PROGRAMS NEED IMPROVEMENT

For IRS to effectively detect and deter nonfilers and underreporters, it needs to make specific changes to its collections, document matching, withholding, audit and criminal investigation activities.

Collections

Our audit of IRS' efforts to detect and deter nonfilers showed that it needed to use its collection resources more effectively in this area. The Collection Division is the key IRS unit responsible for ensuring that taxpayers file their returns.

Until our July 1979 report, 2/ IRS had neither an estimate of the extent of nonfiling or its impact on the voluntary tax assessment system. We estimated that of the 5 million individual taxpayers who were required to file in 1972 but did not, IRS was only able to catch 600,000, or 12 percent. We felt that IRS needs to know the size and characteristics of the nonfiler population so it could determine where to concentrate its resources.

IRS was selecting potential nonfilers for investigation primarily on the basis of whether a person's income, as shown by certain data, indicated a predetermined tax liability -- not on whether a person is technically required to file. As a result, many people who were not required to file were selected for investigation; while many who may have been required to file were not selected.

We developed a model that determines with a high degree of certainty whether individuals selected for investigation were indeed required or not required to file returns. IRS agreed to create a similar model for nationwide use because it anticipated a backlog of 700,000 nonfiler cases by the end of 1980. Thus, it needed to select the best cases on which to spend its limited resources.

Also, since IRS selected more people than it could thoroughly investigate with its limited resources, its investigative policies and procedures intentionally limited the extent to which they are pursued. Moreover, the policies

and procedures did not ensure that nonfilers, once caught, would file all their delinquent tax returns, or that their returns would be checked to identify unreported income. IRS' more thorough investigation, undertaken at our request, of 389 previously unsuccessfully closed nonfiler cases showed that investigating such cases increased costs but that revenues to the Government outweighed costs 3 to 1.

In our July 1979 report, we made numerous recommendations to IRS and the Congress to improve IRS' efforts to identify and pursue nonfilers. IRS is implementing most of them but has stated that it is limited by the amount of resources it can allocate to its nonfiler program versus other compliance programs.

#### Document Matching

(Payers of wages, interest, dividends and 16 other types of payments are required to report such payments to the IRS. Using its computers, IRS can then match these payments to income reported by taxpayers on their tax returns.

Since 1974, IRS has made considerable progress toward achieving a full document matching program. For that tax year, IRS matched only about 35 percent of the information returns received by IRS and the Social Security Administration. For 1977, IRS matched about 50 percent of the documents it received. For 1978, it matched about 397 million, or about 76 percent, of the 525 million information returns received.

The increase for tax year 1978 can largely be attributed to implementation of the Combined Annual Wage Reporting Program established by Public Law 94-202. Under this program, the Social Security Administration receives all wage information returns and provides the information to IRS on magnetic tape.

The document matching program has proven to be one of the most powerful tools for detecting on a mass scale taxpayers who underreport all or part of their income. According to IRS, the document matching program for fiscal year 1979 is expected to return about \$4 - \$5 to the Treasury for each dollar spent. While exact figures are difficult to determine, the figure for document matching compares quite favorably with those for other tools: from \$4 - \$23 for the various collection programs and \$5 - \$6 for audits. No figures are available for criminal investigations.

In spite of the progress made by IRS, opportunities, which I will now discuss, still exist to strengthen the document matching program.

Payers do not submit all documents

One of the continuing problems with the document matching program is that payers do not submit all required information documents and IRS has not yet developed the means to ensure compliance with submission requirements. IRS studies have consistently shown that payer noncompliance is a serious problem, particularly among payers of miscellaneous income, such as nonemployee compensation, rents, and royalties.]

Currently, IRS' main tools for detecting payer noncompliance are the "package audit" and "full compliance check." The former is a procedure whereby taxpayers being audited for any reason are also checked for compliance with the information return requirements. The latter is a procedure whereby taxpayers being pursued by the Collection Division are also checked for general compliance with other IRS requirements, including those for information reporting. These checks are selective in nature, and little information is available on their overall effectiveness.

IRS has recently undertaken actions which may make it possible to detect on a mass scale payer noncompliance in the filing of withholding (Form W-2) information documents. Under the Combined Annual Wage Reporting Program, IRS matches end-of-year employer-provided withholding documents against the sum of employee wages and payroll taxes paid shown on their quarterly tax returns. Although the program is directed towards ensuring that employers pay the correct payroll taxes, it also makes it possible for IRS to catch some payers who fail to submit all required W-2 documents. IRS has also begun a study which is intended to determine the potential for matching form 1096s (the transmittal documents used for submitting form 1099s) against IRS' business tax return master file in order to detect noncomplying payers.

To provide better assurance that payers file required documents, we continue to support a Treasury Department

proposal to increase the current penalty of \$1 per return with a maximum of \$1,000 per year to 5 percent of total unreported payments.

Millions of submitted  
documents go unused

Many documents filed by payers are not used. For example, about 128 million of the 525 million documents received by IRS and Social Security for tax year 1978 were not matched against tax returns.

IRS has sufficient computer resources to process all the returns but says it would need additional staff and funds to transcribe the paper returns and to work the increased number of cases which would occur. For example, IRS estimated in its fiscal year 1981 budget submission that to increase the number of paper returns used from the current level to 100 percent would require an additional \$40 million. While this estimate assumes manual transcription of paper information returns, automation would reduce costs of processing. Social Security uses optical scanning equipment to transcribe about 60 percent of the paper W-2 returns it receives. We believe IRS should explore the possibility of using similar automated methods for non-wage returns. IRS should also increase the number and improve the quality of returns filed on magnetic media, as these do not require transcription.

Finally, IRS needs to ensure that it is effectively and economically dealing with the problem that many information



documents are submitted without a taxpayer identification number or with an incorrect number. No data exists to show if IRS' efforts to obtain the correct number are cost beneficial. Even if they are, IRS needs to improve the effectiveness of its programs for accomplishing more accurate payer reporting. In this regard, IRS generally does not assess penalties on payers who submit documents lacking the taxpayer's identification number.

More Income Could be Subject  
To Document Matching

Because document matching is a powerful tool to identify and pursue noncompliance on a mass scale, finding ways to include more income under the program should be a key part of the agency's efforts to deal with the underreporting and non-filing problem. Potentially, more income could be subjected to information reporting and matching. For example, most interest paid in tax year 1978 on marketable U.S. public debt obligations--Treasury bills, notes, and bonds--is not subject to information reporting. Efforts are underway to establish a "book entry" system on these bearer securities in which the purchaser's name and social security number would be recorded to help identify interest received. IRS has been working with the financial community to develop some type of information reporting for this interest and also for that which is paid to individuals who hold other (nongovernment) bearer-type securities.

Sources other than the information documents now used in the matching program could also be used for matching income paid to the taxpayer's return. For example, IRS is researching the feasibility of obtaining and matching State tax refund data. Other surrogate information documents may also be available. For example, a 1040 return containing an alimony deduction could possibly be used to determine if the recipient reported the alimony as income.

Computerized Operations Could be  
More Efficient and Effective

As described in our October 1980 report on IRS' computer capabilities for matching information returns to tax returns, 3/ IRS also has opportunities to improve the computerized processing of information returns and its overall computer productivity. During 1979 IRS made a comprehensive study of the information returns program and recommended a streamlined system design for processing returns. According to the study, file size and processing time could be reduced by about one-half throughout the information returns processing system. Also, we found that better matching between job requirements and computer resources could substantially improve computer productivity at the National Computer Center. A concerted effort is thus needed on the part of IRS to redesign the information returns processing system and improve computer productivity. It is also needed to prevent roll-over of old, inefficient procedures to the new computer equipment IRS is

planning to acquire. IRS is currently taking action to improve its computerized operations.

Related to IRS' computerized operations is its need for a management information system for proper program planning and evaluation. To plan and manage the matching program, it needs information on the (1) amount and relative importance of unreported income that the program can be expected to reach and (2) extent to which the program covers the total unreported income problem.

IRS also needs information to assess the effectiveness of the program internally. For example, about one-half of the potential underreporters identified by IRS are not pursued. Some are not even identified as cases because of various money or status drop criteria applied by the computer and by IRS staff. IRS lacks information on how many such drops occur and on the relative significance of each drop criteria. Consequently, IRS does not know how many underreporters or how much unreported income the matching program actually detects.

Many cases are also dropped because they are invalid, thus wasting staff resources expended on them up to that point. The taxpayer may have recorded the income on the wrong line of the return or made offsetting errors, or IRS could have made a mistake in the process. IRS could refine its process to identify such cases earlier.

IRS is taking various steps to meet its need for management information in the document matching area.

## Income Tax Withholding

Besides document matching, withholding at source is the best way in the long run to assure the continued integrity of a voluntary tax assessment system. There are three major questions involving the use of withholding: (1) how much underreporting do existing withholding provisions prevent? (2) should additional types of income be subject to tax withholding? and (3) how much document matching is needed for those incomes subject to withholding?

As IRS' August 1979 report on unreported income confirmed, voluntary reporting is very high when incomes are subjected to withholding. It is lower when incomes are subject to information document reporting, and even lower when incomes are subject to neither withholding nor information document reporting.

IRS and the Treasury Department want more income types subject to withholding because of the income underreporting problem. Last year, with our Office's support, they proposed, that Congress authorize withholding at source 10 percent of the payments made to independent contractors. An IRS study had indicated there is widespread noncompliance by independent contractors.<sup>4/</sup>

Treasury and IRS have also advocated a withholding system for interest and dividends. However, the Congress has continually rejected proposals for such a system on the basis that IRS should make full use of document matching

before subjecting the public to the burden of more withholding. Since IRS is now making greater use of document matching and has better information on the nature and extent of the underground economy, it should be in a better position to determine the costs and benefits of subjecting more income types to tax withholding.

### Audits

IRS considers the taxpayer audit or examination to be its most significant enforcement effort. Because audits are directed at persons who file returns, they can be expected to impact much more on underreporters than nonfilers. However, IRS audits have not been as effective as they might be in detecting underreporters because

- IRS has had inadequate data on the amount of underreported income detected by its audits.

- IRS' process for selecting returns for audit has been more deduction-oriented than income-oriented.

- IRS' annual examination plan does not allow enough time for examiners to do the type of audit work necessary to identify unreported income.

IRS is engaged in strengthening its efforts to discover and tax unreported income through audit, making two important changes. It has implemented a new system which will allow its auditors to associate information documents with tax

returns at the time returns are selected for audit. It has also implemented a program to strengthen the withholding system by examining and verifying questionable withholding exemption certificates (W-4 forms).

#### Criminal Investigations

IRS' Criminal Investigation Division plays a vital role in detecting underreporters and nonfilers, particularly those who derive their income from illegal sources. The complex and devious nature of schemes involving illegal activities limits IRS' ability to detect and deter the tax evasion which goes hand-in-glove with those activities. Routine audits and collection actions have little chance of detecting such schemes, which often involve no "paper trail." However, IRS has special agents assigned to the Criminal Investigation Division who are specifically trained and authorized to deal with those schemes.

Properly directed, special agents should be able to make a substantial impact on the problem of unreported income arising from illegal activities. However, as we stated in our November 1979 report on IRS' development and selection of criminal tax cases, 5/ IRS has not been as effective as it could be in dealing with the tax fraud problem, let alone detecting nonfilers and underreporters who derive their income from illegal activities. This was due primarily to the lack of a well-defined National strategy for dealing with tax fraud and the lack of adequate National direction.

A lack of effective National direction and control has been particularly distressing from the standpoint of illegal activities, because the Criminal Investigation Division does have one key investigative technique--information gathering--which enables special agents to get at pockets of noncompliance that might otherwise go untouched and to detect complex and devious tax evasion schemes. However, its value and impact have been limited because IRS had made little effort to coordinate the information gathering activities of its the 58 district offices.

In recent years, IRS has recognized the inadequacy of the guidance it provides special agents at the district level and has initiated actions to correct the problem. These include plans for allocating more resources to pockets of noncompliance in the legal sector of the underground economy and to major narcotics cases in the illegal sector. More recently, IRS established a task force to examine resource allocation in the criminal investigation area and establish an appropriate strategy for that area. However, any decisions should be made in the context of an overall compliance enforcement strategy.

THE FEDERAL GOVERNMENT NEEDS AN  
OVERALL TAX COMPLIANCE ENFORCEMENT  
STRATEGY

Although IRS has a range of enforcement programs and activities to combat the underground economy, they must be combined in a strategy which seeks to maximize voluntary compliance among all taxpayer groups. Historically, IRS allocated the greatest share of its compliance resources to

its audit or examination program because it believes examining returns stimulates voluntary compliance more than investigating taxpayers, matching documents, closing delinquent accounts, or conducting other compliance-related activities. From fiscal year 1974 to 1979, IRS allocated an average of 62.4 percent of its compliance resources to examinations even though the percentage of returns audited during this period dropped from 2.4 to 2.2 percent.

In its financial plan for fiscal year 1979, IRS allocated about \$713 million, or 61 percent, of the total \$1.2 billion in compliance resources to the examination program. Of the remainder, IRS allocated \$275 million (24 percent) to collections, \$128 million (11 percent) to criminal investigations, and \$51 million (4 percent) to document matching. IRS allocated the other \$1 billion of the \$2.2 billion appropriation to activities not directly related to compliance, such as returns processing and taxpayer service.

Allocating resources this way may not assure coverage of identified noncompliance target areas in proportion to their importance. For example, a greater positive effect on voluntary compliance might be achieved by putting additional compliance resources into the document matching program as opposed to the examination, collection, or criminal investigation programs. But, unless IRS looks at all four programs within the context of how they as a whole foster increased compliance among targeted groups, IRS cannot effectively make such a decision.



In the short term, the level of IRS' audit activity should not decline. There can be no adequate assurance that the integrity of our voluntary tax assessment system is being maintained if IRS audits fewer returns while the number of taxpayers increases. The Congress took positive action in this regard by directing IRS to maintain quality audit coverage of 2.24 percent in fiscal year 1980 and by allowing approximately 750 additional positions for this purpose. Similar congressional action is likely in fiscal year 1981 so that IRS' coverage does not drop below 2.24 percent level.

In the long term, IRS needs to develop a comprehensive strategy to assure the most effective use of its compliance resources. In this regard, it has to assess the extent to which its various compliance programs are impacting on identified areas of noncompliance. Then, it has to assure that its planning process adequately directs the various programs and resources toward overall compliance goals and issues.

Developing adequate information on the extent and make-up of nonfiling and underreporting is essential to developing a National strategy for combatting noncompliance. IRS' August 1979 report on unreported income was an important first step. However, IRS should periodically update its estimates of the extent to which an underground economy exists and refine its data so that trends can be developed, pockets of noncompliance isolated, and resource allocation decisions made. Also, more research needs to be done to determine exactly who the underreporters and nonfilers

are, what type of income they are receiving, and why people either do not pay or underreport their income for tax purposes.

GOVERNMENT POLICY CONSIDERATIONS ;

While IRS can improve the efficiency and effectiveness of its efforts to deal with the underground economy, it is impeded by the complex inequitable tax laws and lack of resources. Therefore, the Federal Government should consider appropriate policy changes.

Although we have not seen any empirical data to support this assumption, it seems that some people are reluctant to report all or part of their income because they perceive that our current laws are unfair and are designed to benefit wealthy taxpayers more so than the average taxpayer. Reform of the tax laws and simplification of the Internal Revenue Code should help reduce such taxpayers' antipathy.

In this regard, it is interesting to note that in passing the Revenue Act of 1978, the Congress provided a much larger percentage of tax cuts, in relation to those cuts proposed by the Executive Branch, for the upper income classes than for the lower and middle classes. Specifically, the Act provided about 803 percent of the amount of tax cuts proposed by the Executive Branch for persons in the \$50,000-\$100,000 income range; but only about 50 percent of the amount of cuts proposed for those earning less than \$15,000. I highlight these statistics because they might help explain why many people are beginning to perceive that the way they can beat the

system is not to take advantage of the law as it exists, but rather to not report all of the income they earned.

The Government may also want to reassess (1) its policy for determining IRS' funding levels and (2) the adequacy of IRS resources to deal with the noncompliance by the underground economy problem. In this regard, despite the fact that IRS is a revenue generating agency, it has generally been treated like other agencies during this period of reduced Federal spending. It has not received any significant increases in its compliance resources and some aspects of those resources have been cut. For example, between 1975 and 1979, staff years devoted to collecting delinquent taxes were cut by nearly 10 percent.

Recently, however, the Congressional Appropriations Committees and other committees have expressed concerns over "eroding compliance" and made some efforts to boost IRS' budget. For example, a House Government Operations Subcommittee raised concerns over document matching budget cuts in light of IRS' position that an annual increase of \$100 million in document matching funds could produce \$500 million a year in tax collections. The Senate and House Appropriations Committees recently recommended large increases in IRS' audit, collection, and criminal investigation budgets. This trend may continue in light of the forthcoming Administration's intention of balancing the Federal budget. For

in addition to eliminating waste and fraud, what better way to balance the budget exists than to collect outstanding income taxes?

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To sum up the situation, there are no easy solutions to the underground economy problem. Indeed, we have to be very concerned about overreacting to it and developing draconian measures which are contrary to the basic precepts of our society. But the evidence suggests that unless the Federal Government takes effective action to better enforce our Nation's tax laws, the voluntary tax assessment system could be subjected to increasing strain. To avoid this, the Executive Branch and Congress can both do their part.

## FOOTNOTES

- 1/Department of the Treasury, Internal Revenue Service, Estimates of Income Unreported on Individual Tax Returns, Publication 1104, U.S. Government Printing Office, August 1979.
- 2/General Accounting Office, Who's Not Filing Income Tax Returns? IRS Needs Better Ways to Find Them and Collect Their Taxes, (GGD 79-69, July 11, 1979).
- 3/General Accounting Office, IRS Can Expand and Improve Computer Processing of Information Returns (FGMSD-81-4, October 20, 1980)
- 4/Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, testimony before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, June 20, 1979.
- 5/General Accounting Office, Improved Planning for Developing and Selecting IRS' Criminal Tax Cases Can Strengthen Enforcement of Criminal Tax Laws (GGD-80-9, November 6, 1979).